Supreme Court, U.S.
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No. 88-1554

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1988

CORRECTED COPY

VINCENT E. DAVIS, Petitioner,

v.

HENRY HIMMELFARB; CHARLES T. HAYS; RICHARD A. EDWARDS; GOLDEN ARROW GAS ENERGY CORPORATION; JIM KITCHENS; RONALD G. MILLER; RUTAN & TUCKER; ROBERT PIKE; EMPIRE EQUITIES; RONALD GARRETT, Respondents.

ON WRIT OF CERTIORARI TO
THE COURT OF APPEALS
FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Is Davis' Note A Security:

Is a four-year note for $400,000, a "security" for purposes of the anti-fraud provisions of the federal securities laws, when it is issued by an insolvent corporation, which has abandoned its prior enterprise, in connection with a public solicitation for Mexican currency to raise venture capital to commence a new enterprise, if the issuer fraudulently represents to the note-holder that the note is secured by a first trust deed, when in fact the note is not at all secured because it is subordinate to two prior liens totalling an amount ($1,295,000) equal to approximately three times the value of the real property collateral, and where the note-holder's Mexican currency is the venture capital used by the issuer to commence the new enterprise, the success of which will determine if the note-holder is paid?

2. Question 2: Dismissal of Ancillary Claims

If a defendant is brought into federal court in a foreclosure action founded on diversity because he has a lien on real property subordinate to plaintiff first mortgagee, and the defendant properly assets cross-claims under federal securities laws and state securities and fraud laws under Rule 13(g) against co-defendants, and against parties he joins under Rule 13(h) (all of whom are diverse from plaintiff), and the cross-claims are severed for a separate trial under Rules 42 and 13(i), after which plaintiff's foreclosure claim proceeds to trial, resulting in a judgment for plaintiff, and defendant's cross-claims are then transferred for trial to another district for the convenience of witnesses, can the judge in the transferee court dismiss the state cross-claims if it concludes on a

motion for summary judgment just prior to trial that defendant's federal cross-claims must be dismissed because the instrument at issue is not a "security", even though the remaining state cross-claims are within the trial court's ancillary jurisdiction? If the trial court has such discretion, has that discretion been abused where the action has been pending for over three years, is within months of trial and the parties have conducted extensive discovery?

LIST OF PARTIES

The caption of the case in this Court contains the names of all the parties to Davis' cross-claims in the court below, but does not include plaintiffs, or those defendants who were not parties to Davis' cross-claims, and were only defendants to plaintiffs' claims. Those additional parties were:

1. Plaintiffs Robert E. Danner, Char_tte Danner and Gadan, Inc.;

2. Craig S. Kendell, defendant;

3. Southern California Properties, defendant;

4. Skip Bales, defendant;

5. Penguin Properties, defendant;

6. Huntingdon Escrow Service, defendant;

7. Security National Bank & Trust Co. of Norman, Oklahoma, defendant.

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Vincent E. Davis

DECISIONS BELOW

The decisions of the courts below which are sought to be reviewed, beginning with the most recent decision of the court of appeals, are as follows:

1. Danner, et al v. Himmelfarb, et al, and related cross-actions, 858 F.2d 515 (9th Cir. 1988), App. 22.

2. Danner, et al. v. Himmelfarb, et al. and related cross-actions, (U.S.D.C. Case No. 85-7661-RJ), (C.D. Cal. 1987), (Unpublished memorandum of decision and order, and judgment thereon), App. 1.

THIS COURT'S JURISDICTION

The decision of the court of appeals was made and entered on September 28, 1988.

An order denying rehearing was made and entered on December 15, 1988.

Therefore, this Court has jurisdiction to review the decision in question by writ of certiorari under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

Question No. 1 (Is The Note A Security?):

The Securities Act of 1933, and the Securities Exchange Act of 1934, both define a security to include "any note". Specifically, the 1933 Securities Act, 15 U.S.C. § 77b(1) states:

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-

> trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77c(a)(3) exempts notes payable in nine months or less from the 1933 Act's registration requirements:

> ...the provisions of this subchapter shall not apply to any of the following classes of securities:
>
> ...Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of

> days of grace, or any renewal thereof the maturity of which is likewise limited;

However, 15 U.S.C. § 77q(c) provides that the exemption set forth above shall not apply to the 1933 Act's anti-fraud provisions, i.e., 15 U.S.C. § 77q(a), (b).

> The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

The Securities Exchange Act of 1934 also defines a security to include "any note", if it matures in more than nine months. 15 U.S.C. § 78c(a)(10) provides:

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to

> subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Question No. 2 (Did the Trial Court Err in Dismissing Davis' Ancillary State Law Cross-claims?):

No statute defines the trial court's ancillary jurisdiction. The trial court's jurisdiction over plaintiffs' claim of foreclosure was premised on diversity of citizenship, 28 U.S.C. § 1332. Petitioner Davis, a defendant in plaintiffs' action, filed cross-claims against some of his co-defendants pursuant to Rule 13(g), F.R.C.P. Rule 13(g) provides:

> A pleading may state as a cross-claim any claim by one party against a co-party arising out of the transaction or occurrence that is the subject matter either of the original action or of a counterclaim therein or relating to any property that is the subject matter of the origi-

> nal action. Such cross-claim may include a claim that the party against whom it is asserted is or may be liable to cross-claimant for all or part of the claim asserted in the action against the cross-claimant.

Petitioner Davis also joined additional cross-defendants to respond to his cross-claims under Rule 13(h), F.R.C.P., which provides:

> Persons other than those made parties to the original action may be made parties to a counterclaim or cross-claim in accordance with the provisions of Rules 19 and 20.

STATEMENT OF THE CASE

1. Facts (and Course of Proceedings):

This lawsuit arises out of the use, through a complicated series of transactions, of two parcels of Oregon real property to raise capital for certain corporations. Petitioner Davis advanced U.S. $400,000 worth of Mexican pesos for a note, which certain cross-defendants

represented would be secured by a first trust deed on one of the Oregon parcels, only to discover later that he was, in fact, in third position, subordinated to $1,295,500 in prior liens on property worth no more than $462,000. Thus, Davis was not secured at all.

In December, 1981, cross-defendants Hays and Himmelfarb purchased two parcels of contiguous real property in Oregon from plaintiffs Danner and Gadan (hereinafter, "plaintiffs Danner"). One parcel was 14 subdivided lots (hereinafter, the Oregon "lots"). The other parcel was undivided farm acreage (hereinafter, the "farm"). Hays and Himmelfarb executed a trust deed on the Oregon lots in favor of plaintiffs Danner to secure a $155,000 note, which evidenced part of the purchase price. App. 25-26.

In late 1981 and early 1982, Himmelfarb and Hays, and another cross-defendant

Edwards (all of whom lived in California), were approached by cross-defendants Miller and Kitchens, who were directors, officers and controlling stockholders of several Oklahoma corporations involved in the oil and gas industry, including Golden Arrow Gas Energy Corporation ("GAGE"). GAGE and the Oklahoma corporations were having cash flow problems because of the 1981-1982 recession, and Miller and Kitchens asked Himmelfarb, Hays and Edwards to assist them in restructuring the corporations' debt, and in obtaining additional loans from the corporations' bank, Security National Bank & Trust Co. of Norman, Oklahoma ("Security National Bank"). Miller and Kitchens gave Himmelfarb, Hays and Edwards stock in the Oklahoma corporations, and other consideration, for their efforts, and to induce Hays and Himmelfarb to offer real estate to Security National Bank as collateral for additional loans.

Hays, Himmelfarb and Edwards then joined Miller and Kitchens as controlling directors, officers and stockholders of GAGE and the other Oklahoma corporations. Hays and Himmelfarb did offer both Oregon parcels (the farm and the Oregon lots) as collateral to Security National Bank, and in May, 1982, Hays and Himmelfarb executed trust deeds in favor of Security National Bank on both Oregon parcels to secure a note of $1,140,000 (the amount of new money Security National Bank advanced to GAGE), and the deeds were recorded in June, 1982. App. 26; Depo. of Edwards, Vol. I, pp. 26-39, 41-47, 50; Vol. II, pp. 76-85; Depo. of Hays, pp. 14-32; Depo. Ex. 137, pp. 3-4; CR: 453, 458.

At the same time, Miller and Kitchens were looking for a "shell" corporation whose stock was publicly traded; they wanted to merge GAGE and the other Oklahoma corporations with a publicly-traded

corporation to realize more for their investment. Miller and Kitchens believed that publicly-traded stock in oil and gas corporations sold at a much higher multiple of the price-earnings ratio than stock in a privately-held oil and gas corporation. Miller and Kitchens also believed that by going public, they could raise capital without paying interest (i.e., by obtaining cash in the form of investments, as opposed to loans). Depo. of Iseli, pp. 4-10; Depo. of Edwards, Vol. II, pp. 8, 24, 25-36; Depo. of Miller, pp. 57-62; Depo. of Hays, pp. 41-43, 156, 158, 167-171, 179-180; Depo. of Kitchens, pp. 320-321, 331-337, 348-350; Depo. Exs. 111-119, CR: 453, 458.

Cross-defendant Empire Equities was a California corporation whose stock was publicly traded. Empire provided management services to a health insurer, Citizens Health Plan, a nonprofit health

insurance corporation. Citizens had no employees, and Empire's employees provided the labor to manage and operate Citizens. In August, 1982, Citizens' health plan was audited by the State of California, and the State found that Citizens was insolvent, and had at least one million dollars more in claims than it could pay. The state said it intended to issue a "cease and desist" order prohibiting Citizens from transacting any more business unless sufficient additional capital was transferred to Citizens to cure the deficiency. Since Empire's sole asset was its management contract with Citizens, Empire could earn no income if Citizens ceased operations. Empire directors frantically sought to raise the required capital. Mr. Hays learned about Empire's plight through cross-defendant Stepp, in-house counsel for a local securities firm, and called the other directors of GAGE. Directors of

GAGE met with directors of Empire over the labor-day weekend, and negotiated an agreement in principle by the terms of which Hays, Himmelfarb and Kitchens agreed to transfer real property with a net worth of $1,329,000 to GAGE, which in turn would transfer the real property to Empire for 80% of Empire's stock. The real property they agreed to transfer were the two Oregon parcels (still in Hays' and Himmelfarb's names, and still encumbered), and a lot in San Marino, California owned by Mr. Kitchens. A formal agreement was signed in October, 1982 between Empire and GAGE (hereinafter the "exchange agreement") whereby GAGE agreed to transfer the real property, and Empire agreed to authorize and issue stock such that GAGE would own 80% of all its outstanding stock. In the exchange agreement, GAGE represented to Empire that the San Marino lot was worth $375,000, and was encumbered

only by a $125,000 lien; GAGE also represented that the Oregon properties were worth $1,209,000, and that only the farm was encumbered with a $130,000 lien in favor of the VA. The exchange agreement was prepared by Mr. Robert Pike, of the law firm of Rutan & Tucker, who represented Empire. The exchange agreement, and the deeds, warranted that the Oregon lots were free and clear, and the farm was subject only to the $130,000 V.A. loan. The law firm ordered title reports on the farm and San Marino lot, but inadvertently failed to order a title report on the Oregon lots. The title report on the farm revealed GAGE's trust deed to Security National Bank for $1,140,000. Empire's lawyers insisted that that lien be removed, and GAGE did obtain a release of the lien by offering Security National Bank a trust deed on other property. However, because Empire's lawyers did not

obtain a title report on the Oregon lots, Empire did not know that both plaintiffs Danner and Security National Bank had liens on the Oregon lots. At closing, Empire's lawyers asked for title insurance on all three parcels, but the title company refused to issue a title policy on the Oregon lots because it had not researched the title. The title company offered to research the title, and issue a title policy, but the title company informed Empire's lawyers closing would thereby be delayed. Empire's lawyers told the title company to record deeds on all three parcels without a policy on the Oregon lots. Even before closing, Empire's law firm knew that Empire intended to use the real property to raise capital. The appraised value of the lots in 1982 was $462,000. The encumbrances on the lots totalled $1,295,000, not including interest. Thus, Empire got nothing from

the lots.[1] Depo. of Stepp, Vol. I, pp. 10-11, 14, 17, 26, 35, 39-40, 46-48, 51-58, 60-61, 70, 137, 152, 172-173; Depo. of Hays, pp. 38-40, 47, 55; Depo. Exh. 107, CR: 453, 458.

Cross-defendants testified in depositions that they intended to cause Empire to transfer the real property to Citizens to cure the deficiency, and induce the state to lift the cease and desist order. However, after the exchange agreement was signed, and before closing, the state informed the directors of GAGE and Empire that real property would not be a satisfactory capital contribution, and the contribution had to be cash. The directors of GAGE decided to proceed with the transaction in any event because it was a way

[1] When they were sold at a Marshal's sale pursuant to the judgment of foreclosure, they brought $250,000, less than the principal, interest, taxes, fees and costs due on plaintiff Danners' first lien.

to acquire a controlling interest in a publicly-traded corporation. After the transaction closed, GAGE replaced Empire's directors and officers with directors and officers of GAGE, and caused Citizens to file bankruptcy. Gage formed a new corporation called LaTerre Drilling and Exploration, and intended to transfer the stock of GAGE and the other Oklahoma corporations to LaTerre, liquidate those corporations into LaTerre so that LaTerre would own their assets and, then, through a reverse triangular merger under section 357 of the Internal Revenue Code, merge LaTerre into Empire. GAGE prepared a financial statement which represented that the consolidation had already occurred, even though it had not, and the statement was disseminated to some members of the public. Depo. of Stepp, pp. 11-12, 19-23, 50, 67, 70-72, 75, 85; Depo. of Edwards; Vol. II, pp. 76-85, 98-101, Vol. III,

pp. 110, 174-180, Depo. of Tanner, pp. 12-32; Depo. of Kitchens, pp. 172-176, 280-281; Depo. Exs. 136, 139, CR: 453, 458.

Because Empire had no income from Citizens, GAGE decided to cause Empire to embark upon a new enterprise. GAGE knew of property in El Tequan, Mexico, which GAGE believed was an ideal location for a "Club Med" type resort. GAGE secured an option from the owner to purchase the property for Empire, and decided Empire should develop El Tequan. GAGE decided to offer oil and gas futures through Empire, to Mexican nationals and Americans with pesos in Mexico, in exchange for their pesos. Empire could then use these pesos to develop El Tequan. In the last half of 1982, the peso began a dramatic slide down against the dollar because of the decline in oil prices in Mexico, and other economic ills. The Mexican official exchange rate between pesos and dollars was more

favorable than the free-market exchange rate at currency exchange houses along the U.S.-Mexican border. However, the Mexican official exchange rate was illusory, because the Mexican government, to avert a disastrous flight of capital, would not permit dollars obtained (and one could not obtain many dollars because they were not available) to leave Mexico. Thus, many Mexican nationals and others had their wealth literally held captive in Mexico, and the value of that wealth was evaporating rapidly. One could bring pesos from Mexico, and exchange them at the border, but at much less favorable rates. GAGE believed Empire could capitalize on the plight of those with wealth trapped in Mexico by offering to exchange oil and gas futures at rates which were more favorable than those of the currency exchange houses on the border, but less favorable than the

official rate.[2] GAGE and Empire ran an ad in the Wall Street Journal soliciting pesos. Over 100 individuals responded, and cross-defendants met with numerous individuals, including some, like Mr. Ramon Cabrerra, an attorney from Mexico City, who represented other Mexican nationals interested in exchanging pesos for U.S. assets. Kitchens and Miller testified they had the ability to offer as many oil and gas futures as Empire could sell. App. 26-27; Depo of Stepp, pp. 96-98, 110, 134-140, 176-177; Depo. of Hays, pp. 74-86; Depo. of Edwards, Vol. II, pp. 63, 65-71, Depo. of Kitchens, pp. 176-182; Depo. of Miller, pp. 34-37; Depo. Ex. 128, 306, CR: 453, 458.

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[2] For example, if the official exchange rate was 80 to 1, and the free-market rate at border exchange houses was 150 to 1, GAGE could profit by offering exchange rates somewhere between the official and real rate. They could then use the pesos to purchase goods and services to develop El Tequan.

Petitioner Davis had U.S. $400,000 worth of pesos in Mexico. Mr. Davis' daughter worked for Empire. After Empire began its solicitation campaign for pesos, Mr. Davis' daughter learned of it, and told Mr. Stepp, who had been appointed by GAGE as an officer and house counsel for Empire, that her father had pesos in Mexico. Mr. Stepp and Mr. Hays then met with Mr. Davis and made several proposals to him. Mr. Davis did not accept oil and gas futures, or an interest in El Tequan, so Empire offered Mr. Davis a "first lien" on the Oregon lots, and Mr. Davis agreed to accept a note for U.S. $400,000 and a first trust deed on the lots. Every Empire and GAGE representative Mr. Davis talked to said the lots were free and clear, and Mr. Stepp so represented in writing.[3] Empire executed a note and a

[3] Mr. Stepp testified he believed the lots were free and clear because of his participation in the GAGE-Empire exchange

trust deed in December, 1982 in favor of Davis and Mr. Davis transferred the pesos to Empire. When Mr. Davis invested his pesos in Empire, Empire was insolvent; it had no net worth or cash. In the note, Empire retained the right to substitute different collateral for the lots if it so chose. The principal of the note ($400,000) was not due for four years, until December, 1986. No interest was due for one and one-half years. Mr. Davis could not even accelerate the note in the event of default.[4] Mr. Davis' lien was not a first lien, but was a third lien, and was subordinated to $1,295,000 in prior debt. Since the lots were worth no

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transaction, and his review of the exchange agreement and warranty deeds.

[4] The note said Davis' right of acceleration was controlled by "Exhibit A attached to the note." However, Exhibit A was a description of the Oregon lots, and said nothing about acceleration. Depo. Ex. 201, CR: 453, 458.

more than $462,000, Mr. Davis had no security at all for his note. App. 27-28; Depo. of Davis, pp. 55, 60, 68, 71, 73, 81; Depo. of Stepp, pp. 104-108, 113-114, Depo. Ex. 202, 217; CR: 453, 458.

Shortly thereafter, tension developed between Miller and Kitchens on the one hand, and Hays, Edwards and Himmelfarb on the other. The latter agreed to exchange their stock in GAGE and the other Oklahoma corporations for GAGE's stock in Empire. Hays, Himmelfarb and Edwards then took control of Empire, and tried to raise additional pesos to develop El Tequan. Empire used Mr. Davis' money to pursue this enterprise, and also brought some pesos to the border, and exchanged them for dollars. Without Mr. Davis' investment, Empire would not have been able to continue in business. Empire, ultimately, became insolvent and filed for bankruptcy. It defaulted on the first interest payment

due in April, 1984.[5] App. 28-30; Depo. of Stepp, pp. 63-64, 92, 119, 125, 130, 142, 198; Depo. of Hays, pp. 106-108; Depo. of Edwards, pp. 120-121; Depo. Exs. 136, 307; CR: 453, 458. However, prior to Empire's default, defendants Hays and Himmelfarb defaulted on their debt to plaintiffs Danner and in February, 1984, plaintiffs Danner commenced this action in the United States District Court for the District of Oregon to foreclose their first trust deed on the Oregon lots. Plaintiffs named Empire, the fee owner, and the second and third trust deed beneficiaries, namely Security National Bank and Mr. Davis. Plaintiffs also joined and sued other defendants for breach of contract, breach of fiduciary duty and fraud. These other defendants included Hays, Himmelfarb, and

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[5] Davis has never received any payments of principal or interest on his note.

Edwards. Mr. Davis answered, and cross-claimed under Rule 13(g) against Hays, Himmelfarb, Edwards and Empire for securities fraud under state and federal law (the 1933 and 1934 Acts), for failure to register and for intentional and negligent misrepresentation. Davis later joined additional defendants under Rule 13(h) to answer his cross-claims, namely GAGE, Miller, Kitchens, Stepp, Garrett, Rutan & Tucker and Pike. Prior to the trial on plaintiffs' foreclosure claim, Davis' cross-claims were severed for separate trial (Order severing cross-claims dated May 28, 1985, CR: 183). Plaintiffs' claim of foreclosure came on for trial in July, 1985, and judgment was entered for plaintiff on August 6, 1985 foreclosing plaintiffs' first lien against Empire, and against the subordinate liens of Security National Bank and Davis. Cross-defendants moved to transfer trial of Davis' cross-

claims for trial to the U.S. District Court for the Central District of California, for the convenience of witnesses, and that motion was granted by the Oregon District Court in October, 1985.[6]

This case was pending in the District Court of Oregon for approximately one year and eight months before Davis' claims were transferred, and the parties had filed 263 separate pleadings and papers in the district court, and taken eleven depositions. After the case was transferred, the parties filed another 208 pleadings, including briefing and arguing motions directed

[6] In its opinion in this case, the Court of Appeals incorrectly stated that the district court granted the motion to transfer venue before the foreclosure action was resolved. App. 41. The motion to transfer was granted after trial and judgment were entered. (Record of court trial, July 11, 1985, CR: 229; Judgment, August 6, 1985, CR: 240; Order transferring venue of cross-claims dated October 30, 1985, CR: 251).

at Davis' cross-claims,[7] and took 23 additional depositions. The case was pending in the Central District of California for another year and six months. After more than three years in litigation, discovery cutoff was set for June 15, 1987, the pretrial conference was set for July 20, 1987, and the parties were looking for a fall, 1987, trial date. Notices, CR 133-139, 195, 196, 202, 203, 213, 366-381, 383-387, 391-395, 400-409, 411, 413, 427-429, 434-436, 444-452, 453, 456-458; Order, CR: 425.

Cross-defendant Himmelfarb then filed a motion for partial summary judgment in the Central District in which cross-defen-

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[7] Davis' cross-claims for failure to register under the federal securities law, and for fraud and failure to register under California securities law against GAGE, Kitchens and Miller were dismissed on the grounds of statute of limitations, and for failure to register under Oregon securities law against defendant Miller on the same grounds.

dants GAGE, Kitchens and Miller joined, contending that the Empire note was not a "security", because Mr. Davis asked for collateral, and believed the note was "secured" by the trust deed. The trial court relied on the "risk capital" test of Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976), and ruled that the note was not a security, and dismissed Davis' federal securities claims with prejudice. The trial court then dismissed Davis' remaining state law securities cross-claims and common law misrepresentation cross-claims because they were "pendent" claims and, having dismissed the federal claims, held the pendent claims should be dismissed. Davis appealed to the Ninth Circuit. The Ninth Circuit affirmed the judgment of the district court that the note was not a security, and that the trial court had discretion to

discuss the state claims, and had not abused it.

2. Federal Jurisdiction: Plaintiffs Danner and Gadan (all Oregon residents) filed their action in the U.S. District Court for the District of Oregon against defendants, all California residents. Jurisdiction was premised on 28 U.S.C. § 1332. (There was complete discovery). Mr. Davis filed cross-claims against four of his co-defendants under rule 13(g), F.R.C.P., and joined additional defendants under Rule 13(h), F.R.C.P., to answer those cross-claims. The district court had ancillary jurisdiction over Davis' cross-claims.[8]

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[8] Note Bene: The cross-defendants Davis joined under Rule 13(h) were citizens of California and Oklahoma, and thus did not destroy the diversity between plaintiffs Danner and defendants. (See Third Amended Answer and Cross-Claims, CR: 422). Owen Equipment & Erection Co. v. Kroger, 437 U.S. 365 (1978).

REASONS FOR GRANTING CERTIORARI:

I. Question 1: Is Davis' Note a Security?

The trial court applied the "risk capital" test which the Ninth Circuit has adopted to determine if a note is a security (i.e., an investment) or a risky loan. The trial court relied on the three cases where the Ninth Circuit has applied that test. AMFAC Mortgage Corp. v. Arizona Mall of Tempe, 583 F.2d 426, 432 (9th Cir. 1978); United California Bank v. THC Fin. Corp., 557 F.2d 1351, 1358 (9th Cir. 1977); Great Western Bank and Trust v. Kotz, 532 F.2d 1252, 1257 (9th Cir. 1976). App. 8, 11.[9] The "risk capital" test consists of a six-factor test. Those factors are: (1) the length of time the funds are at risk; (2) the relationship between the amount borrowed and the size

[9] In all three of these cases, the plaintiff was a commercial lender.

of the borrower's business; (3) the borrower's contemplated use of the funds; (4) collateralization, if any; (5) the circumstances of issuance; and (6) the form of the obligation. On appeal to the Ninth Circuit, Davis contended the "risk capital" test should not be applied to his note.[10] Alternatively, Davis argued that even if the risk capital test were applied, Empire's note was a security. (1) Time: Davis' note was for four years, significantly longer than the notes at issue in AMFAC, United California Bank, and Kotz, supra, (two years, one month and ten months, respectively). The trial court apparently agreed with Davis. App. p. 9-10. (2) Relationship of funds to

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[10] Davis pointed out that at least one panel of the Ninth Circuit affirmed a trial court's refusal to apply the "risk capital" test to the purchase by individual investors of notes secured by trust deeds. See, Wright v. Schock, 742 F.2d 541 (9th Cir. 1984), aff'ing 571 F. Supp. 642 (N.D. Cal. 1983), Peckham, J.

borrower's business: the trial court found that Davis' loan was substantial in relation to Empire's net worth, supporting a conclusion the note was a security, but the trial court discounted that finding because Mr. Davis believed he was secured. App. p. 12-13. (3) Contemplated Use of Funds: the trial court acknowledged that Empire, insolvent and out of business, intended to use Davis' funds to start a new venture, but said Mr. Davis believed he could look to his security, and he was not dependent on the success of the new venture. App. p. 13-14. (4) Collateralization: the trial court said that the note was "secured", even though the trial court recognized there was no equity in the property to secure the note. The trial court said that "the mere fact that Davis was deceived does not make the transaction

a security". App. p. 11-12.[11] (5) Circumstances of Issuance: the trial court acknowledged that Empire had solicited pesos from the public, and met with many prospective investors. But, the trial court discounted that fact because Davis learned about Empire's offer from his daughter, and because he negotiated for collateral (even though he did not receive any). App. p. 14-15. (6) Form of Transaction: the trial court again relied on the "secured character" of the note to find that the note was not a "security". App. p. 12.

The 1933 and 1934 Securities Acts both define "security" to include a note of more than nine months unless "the context otherwise requires". 15 U.S.C.

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[11] However, the trial court also said that "defendants' right to substitute collateral renders the importance of collateralization of the loan insignificant." App. p. 11.

§ 77b(1), 15 U.S.C. § 78c(a)(1).[12] The court of appeals below said this Court has "eschewed a literal approach, focusing instead on the economic realities of the underlying transaction. See, e.g., Tcherepnin, 389 U.S. at 336". App. p. 31. The court of appeals said that it had developed the "risk capital" test to distinguish between a "risky loan" and an investment of "risk capital". App. p. 35. The purpose, the court of appeals said, of application of the test, is to determine if a note is a "security" within the meaning of the Acts. App. p. 32-35. Even if a note is, on its face, apparently covered by the Acts, the court of appeals nevertheless believes it must ignore the facial characteristics, and ascertain the "sub-

[12] The language "unless the context otherwise requires" appears in the first sentence of § 2 of the 1933 Act [15 U.S.C. § 77(b)] and § 3 of the 1934 Act [15 U.S.C. § 78c(a)].

stance" based on the "economic realities". App. 32-33.

But in the instant case, the court of appeals said it was not obliged to apply the risk capital test "where the context of the underlying transaction is such that it is clear no 'security' is involved," citing United Sportfishers v. Buffo, 597 F.2d 658 (9th Cir. 1978). App. p. 37. The court of appeals declined to apply the "risk capital" test, but held that Empires' note was not a security because Davis had merely offered to exchange his pesos for a note secured by a trust deed.[13] App. p. 38-39. "Davis sold an asset in exchange for a promissory note secured by a deed of trust". App. p. 39. The court

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[13] This author does not understand the court of appeals' logic. Section 10(b), 15 U.S.C. § 78j prohibits fraud in connection with the purchase or sale of a security. The terms "purchase" and "sale", as defined in 15 U.S.C. § 78c(a)(13), (14) certainly appear on their face to include this transaction.

of appeals acknowledged that the deed of trust was not really a first lien on the property, and that Davis may have been defrauded, but said that cross-defendants' fraud alone did not "implicate the anti-fraud provisions of the Federal Securities laws." App. p. 39. And, "he did not 'lend' Empire money, except to the extent that the sale of asset in exchange for a promissory note represents the seller's loan to the buyer of a portion of the purchase price." App. p. 40. The court of appeals also said Davis did not "invest" in Empire, or expect "profits". App. p. 40.[14] The court of appeals affirmed the trial court's holding on

[14] To say Davis did not expect a profit begs the question. Notes pay interest, but interest is a "return" on an investment. El-Khadem v. Equity Securities Corp., 494 F.2d 1224, 1229 (9th Cir. 1974).

summary judgment but without applying the same standards.[15]

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[15] Davis had argued in the Court of Appeals that the trial court's conclusion that the note was not a security was premised almost entirely on its repeated assertion that Davis believed the note was secured. The trial court relied on Davis' belief to disregard findings which application of the 6-factor "risk capital" test produced supporting the conclusion that the note was a security. The trial court's opinion essentially held that because cross-defendants were successful in defrauding Davis, and making him believe he was secured, they avoided application of the securities laws. Absent the trial court's repeated reliance on Davis' belief, the trial court surely would have concluded that application of the risk capital test indicated Empire's note was a security. To avoid that result, the Court of Appeals simply refused to apply the test, and instead said that "'the nature of an instrument is to be determined at the time of issuance, not at some subsequent time'" citing West v. Multibanco Comermex, 807 F.2d 820, 826 (9th Cir, 1987). The Court of Appeals was obviously referring here to the alleged "secured" character of the note. But both the trial court and the Court of Appeals ignored the reality of the transaction, and instead focused on the form. Davis' note was never, in reality, secured, because there were $1,295,000 in prior liens on property appraised at no more than $462,000.

The court of appeals' reliance on United Sportfishers v. Buffo, 597 F.2d 658 (9th Cir. 1978) was misplaced. In that case, plaintiff exchanged two sports fishing vessels for an assignment by defendants of the proceeds of two land sale contracts, and certain promissory notes secured by deeds of trust. The seller truly sold his fishing vessels, and did not "invest" his vessels. Moreover, the seller had no expectation of a return on the vessels from the land sale contracts or promissory notes, at least not based on any managerial or entrepreneurial efforts by defendants, because the obligors on the land sale contracts and promissory notes were third parties, not defendants.[16]

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[16] In contrast, since Davis was not secured in reality, Davis was entirely dependent on cross-defendants' managerial efforts, and the only way he would be repaid was if their efforts produced a profit.

The court of appeals' reasoning in this case actually elevated form over substance. All loans consist of the "sale" (exchange, transfer) of consideration (cash or other value) for a note or other evidence of debt. But to say that Davis did not "lend" or even "invest" money is to ignore the reality that he was unsecured. The Ninth Circuit supposedly developed its "risk capital" test, and other circuits have developed other tests, to distinguish form from substance in a note transaction, but these tests have operated to exclude notes from the Acts' coverage which, on their face, appear to be included. There presently exists at least three, if not four, different analytical approaches used by the circuits to determine if a note is a security. In, AMFAC Mortgage Co. v. Arizona Mall of Tempe, supra, at p. 431, n. 6, the Ninth Circuit identified three approaches (its

"risk capital" test, the Third, Fifth, Seventh and Tenth Circuit's "investment versus commercial" approach, and the Second Circuit's literal approach). Professor Gary S. Rosin believes there are four approaches, because he believes the Seventh Circuit uses a test different from the "investment versus commercial" test of the Third, Fifth and Tenth Circuits, namely an "impetus of the transaction approach."[17] Professor Rosin has identi-

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[17] That is, in a sale of stock, the impetus comes from the person with the money, and there is an investment; in a loan, the impetus comes from the person who needs the money. To determine the impetus, the Seventh Circuit focuses on three factors: (1) how the business community treats the instrument; (2) how the proceeds are used (e.g., consumer financing versus general business financing); and (3) how the instrument is treated on the borrower's financial statements. CNS Enterprises v. G & G Enterprises, 508 F.2d 1354 (7th Cir. 1975), cert. den. 423 U.S. 825. But that approach ignores the dual impetus (desire to invest, need for capital) on both sides of every transaction involving the exchange of cash for paper, be it a note or stock. Note bene: Davis needed to invest his funds in U.S. assets, just as Empire needed pesos in

fied the First, Third, Fifth and Tenth Circuits as circuits who use the "commercial v. investment" test. Rosin, Gary S., Functional Exclusions From the Definitions of A Security, 28 So. Texas Law Review 333, 339-341 (Nov. 1986). Some of the factors in this test are: (1) number of offers; (2) size of loan; (3) reliance on efforts of issuer; (4) contemplated use of funds; (5) characterization by parties. These factors are designed to distinguish between a "commercial" loan and an "investment" loan. First Circuit: Futura Development Corp. v. Centex Corp., 761 F.2d 33, 41 (1st Cir. 1985), cert. den. 474 U.S. 850; Third Circuit: Lino v. City Investing Co., 487 F.2d 689, 694-695 (3rd Cir. 1973); Fifth Circuit: McClure v. First National Bank of Lubbock, Texas, 497 F.2d 490, 493-494 (5th Cir. 1974), cert.

Mexico.

den. at 420 U.S. 930; Tenth Circuit: Zabriskie v. Lewis, 507 F.2d 546, 551-552 (10th Cir. 1974).[18] The Second Circuit has adopted a literal approach, and has criticized the functional tests of the other circuits. Exchange National Bank of Chicago v. Touche, Ross, 544 F.2d 1126, 1137-38 (2nd Cir, 1976). The Second Circuit has said:

> A party asserting that a note of more than nine months maturity is not within the 1934 Act or that any note is not within the anti-fraud provisions of the 1933 Act has the burden of showing that "the context otherwise requires". 544 F.2d at 1137-1138.

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[18] The Eighth Circuit has apparently adopted a fifth approach in Arthur Young & Co. v. Reves, 856 F.2d 52, 54 (8th Cir. 1988), namely the "economic realities" test which S.E.C. v. W.J. Howey, 328 U.S. 293 (1946) applied to an unusual instrument in order to include that instrument within the definition of "investment contract". But, this court in Landreth, infra, has expressly disapproved of the application of the Howey test to stock, an instrument "plainly within the statutory definition". 471 U.S. at 690. A note is also plainly within the statutory definition.

Professor Rosin argues that except for the Second Circuit, each circuit has relied on its own interpretation of the "general purpose" of the securities laws to develop tests which functionally exclude notes, which would otherwise appear, on their face, to be included. Rosin, id., at 337-341. Many of these cases rely on the phrase "unless the context otherwise requires" to justify this functional approach, but there are good reasons to believe "context" refers to the context of the text of the Act, not the context of the particular transaction. Rosin, id., at pp. 363-364. There is certainly strong evidence in the legislative history that Congress did not intend to exclude notes from the anti-fraud provisions regardless of their treatment of notes under the registration provisions. Hearings on S-875 before Senate Banking &

Currency Comm., 73rd Cong., 1st Sess. 76 (1933).

In Landreth Timber Co. v. Landreth, 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed.2d 692 (1985) this Court reversed a decision by the Ninth Circuit which had used the "sale of business" test to functionally exclude the sale of all the stock in a business from the definition of a security, on the grounds that the buyer had managerial control of the business, and could not depend on the managerial efforts of others.[19] This Court, instead, relied on the plain language of the Securities Acts, noted that such an approach produced certainty, and also noted it avoided arbitrary distinctions which would not further

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[19] The Ninth Circuit noted that its "risk capital" test was analogous to the "sale of business" test because both tests looked beyond the instrument to the "economic realities" of the transaction. Landreth Timber Co. v. Landreth, 731 F.2d 1348, 1352-1353 (9th Cir. 1984), rev'd 471 U.S. 681.

the Acts' purpose to protect investors. 471 U.S. at 693-697. See, also, Gould v. Ruefenacht, 471 U.S. 701, 105 S. Ct. 2308, 85 L. Ed.2d 708 (1985). This Court declined to apply the "economic reality" tests of earlier decisions such as United Housing Foundation v. Forman, 421 U.S. 837 (1975), and S.E.C. v. W.J. Howey, 328 U.S. 293 (1946) (relied upon by the circuits in formulating their "functional" tests) because these cases concerned instruments which were unusual. 471 U.S. at 688-690. This Court reserved the question of whether a note should be deemed a security based solely on its title and characteristics.

Davis urges the Court to now decide the question, and to reject the "risk capital" test, and other "economic realities" tests developed by the circuits, at least as applied to notes in excess of nine (9) months which do not represent

commercial loans from commercial lenders. The decisions of the circuits are in hopeless disarray and conflict regarding notes, and this Court can now state an intelligible, uniform standard, so review is appropriate under Rule 17.1(a), Supreme Court Rules. In addition, the decisions of the circuits, and particularly the instant decision which completely ignores previous ninth circuit precedent, conflict with the recent decision of Landreth, and present an important question of federal law which should be settled,[20] and, therefore, review is appropriate under Rule 17.1(c), Supreme Court Rules.

II. Question 2: Dismissal of Ancillary Claims

The trial court, and the court of appeals, acknowledged that the trial court

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[20] The approach in Landreth also appears to have been used in Securities Indus. Assn. v. Board of Governors, 468 U.S. 137 (1984).

had subject matter jurisdiction over Davis' state law claims. (App., p 17; p. 45). Davis' state law cross-claims arose out of cross-defendants' grant of a lien on the same property plaintiffs Danner were foreclosing. See, U.S. v. Zima, 766 F.2d 1153, 1157 (7th Cir. 1985). The trial court and the court of appeals conceded that dismissal of Davis' federal securities claims did not deprive the trial court of subject matter jurisdiction over Davis' state law cross-claims, including the cross-claims against the cross-defendants Davis joined under Rule 13(h). App. p. 17; App. p. 50. But the trial court said that an independent ground for subject matter jurisdiction had to exist over the "third party defendants" Davis brought in to defend his claims.[21]

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[21] A trial court does not have subject matter jurisdiction over parties. Davis assumes the trial court meant to say it had to have an independent basis for subject matter jurisdiction over the claims

App. p. 18. The trial court then concluded it had discretion to dismiss what it characterized as Davis' "pendent claims" (as to all defendants, joined or not). App. p. 18. The trial court's reasoning was erroneous. The trial court had ancillary jurisdiction over Davis' claims. The trial court would have had ancillary jurisdiction over his state law claims even if Davis had not alleged any federal securities claims. Davis needed no independent basis for jurisdiction of his claims under Rule 13(g), F.R.C.P. against his co-defendants. 6 Wright & Miller, Fed. Practice & Procedure, § 1433, p. 177. Glen Falls Indem. Co. v. United States, 229 F.2d 370, 374 (9th Cir. 1956).

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against the "third party defendants." And, by "third-party defendants", Davis assumes that the trial court meant the additional cross-defendants GAGE, Kitchens, Miller, Stepp, Rutan & Tucker and Pike. Davis did not bring any third-party claims under Rule 14, nor did he join any third-party defendants under Rule 14.

Furthermore, Rule 13(g) makes no distinction between a party to a cross-claim who is one of the original co-defendants, and a party who is joined under Rule 13(h). 6 Wright & Miller, id., § 1431, p. 167. There is no requirement that an independent basis exist for jurisdiction over parties added to a cross-claim added under Rule 13(h) 6 Wright & Miller, id., § 1436, pp. 161-162.[22] As this Court said in Moor v. County of Alameda, 411 U.S. 693, 93 S. Ct. 1785, 36 L.Ed 2d 596 (1973):

> ...[T]he exercise of federal jurisdiction over claims against parties as to whom there exists no independent basis for federal jurisdiction finds substantial analogues in the joinder of new parties under the well-established doctrine of ancillary

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[22] The same rule obtains for a compulsory counterclaim brought under Rule 13(g). 6 Wright & Miller, id., § 1414, p. 69. The same standard ("same transaction or occurrence") governs joinder of compulsory counterclaims under Rule 13(a) and cross-claims under Rule 13(g). And, Rule 13(h) makes no distinction between Rule 19 and Rule 20 parties. 6 Wright & Miller, id., § 1436, p. 192.

> jurisdiction in the context of compulsory counterclaims under Fed. Rules. Civ. Proc. 13(a) and 13(h), and in the context of third-party claims under Fed. Rule Civ. Proc. 14(a). 411 U.S. at 714-715.[23]

The court of appeals below said that the same considerations which govern the exercise of pendent jurisdiction govern the exercise of ancillary jurisdiction, i.e. "judicial economy, convenience, fairness". App. p. 46. While it may be true that such considerations are present in the exercise of both pendent and ancillary jurisdiction, there are additional considerations which govern the exercise of ancillary jurisdiction over cross-claims brought under Rule 13(g) and parties added under Rule 13(h), namely to avoid multi-

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[23] See, also, Aldinger v. Howard, 427 U.S. 1 (1976), dissenting opinion of Brennan, J., p. 22, n. 2, where he notes that no independent basis of jurisdiction is necessary to join a party to a claim asserted under Rule 14.

plicity of actions. 6 Wright & Miller, id., § 1431, p. 161; § 1434, p. 187-188.

The court of appeals refused to recognize the "principled" difference between pendent and ancillary jurisdiction. App. 50-51. But there is at least one such difference. A plaintiff invokes the court's pendent jurisdiction by "appending" his state claims to his federal claim in a federal forum of his choice, but a defendant invokes the court's ancillary jurisdiction in a forum he has not chosen, and into which he has been dragged against his will. County of Oakland v. City of Berkley, 742 F.2d 289, 296 (6th Cir. 1984). Circuit courts have held that a district court retains ancillary jurisdiction of cross-claims even if the plaintiff's claim is settled before trial or is dismissed, as long as it is not dismissed for lack of subject matter jurisdiction. Stamford Board of Education

v. Stamford Education Association, 697 F.2d 70, 72 (2nd Cir. 1982); Fairview Park Excavation Co. v. Al Monzo Construction, 560 F.2d 1122, 1125 (3rd Cir. 1977); 6 Wright & Miller, id., § 1431, p. 163; § 1433, p. 181; n. 45. In Fairview, the third circuit said:

> Once a district court judge has properly permitted a cross-claim under F.R. Civ. P. 13(G), ...the ancillary jurisdiction that results should not be defeated by a decision on the merits adverse to the plaintiff on the plaintiff's primary claim. 560 F.2d at 1125.

This latter opinion suggests that district courts should not dismiss such cross-claims. At least one commentator has also questioned whether ancillary claims, if properly asserted, should be dismissed if plaintiff's claim is dismissed for a reason other than lack of subject matter jurisdiction. See, 13 Wright, Miller and Cooper, id., § 3523, page 106, note 58.

In this case, Mr. Davis did not choose the federal court to litigate his claim. He was forced to litigate there.[24]

The trial court below applied the analytical approach used to decide if it should retain jurisdiction of pendent claims.[25]

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[24] Note, the comments to the 1946 amendments to Rule 13(g) specifically contemplate the Davis situation; i.e., where a first mortgagee commences a foreclosure action against the owner-mortgagor, and joins a second mortgagee. The second mortgagee may then cross-claim against the owner-mortgagor. Advisory Committee Notes to 1946 amendments to Rule 13(g), Appendix to Fed. Rules of Civ. Proc., Rule 13; 5 F.R.D. 446. See, also, U.S. v. Zima, 766 F.2d 1153, 1158 (7th Cir. 1985).

[25] The trial court relied on Safeco Insurance Company v. Guyton, 692 F.2d 551 (9th Cir. 1982), but that case did not concern cross-claims. The case dealt with a defendant's counterclaim against the plaintiff, and another party plaintiff joined to respond to the counterclaim. The trial court in Safeco dismissed defendant's counterclaim against the plaintiff on a motion for summary judgment, and then dismissed defendant's counterclaim against the added party. The Court of Appeals affirmed, but recognized that the pendent jurisdiction invoked by plaintiff in Guyton was different from the ancillary

In affirming the district court, the court of appeals incorrectly stated that Davis' cross-claims were transferred from the District of Oregon to the Central District of California before plaintiff's foreclosure claim was tried. App. 41. The court of appeals then said that after Davis' action was transferred to the Central District of California, it remained what it had been; all further proceedings in it were merely referred to another tribunal. App. p. 42. Davis does not disagree. The court of appeals then proceeded to do what the trial court had done, and analyze Davis' claims under the standards applied to pendent claims. The court of appeals said Davis' joinder of the additional cross-defendants under Rule 13(h) raised the problem of "pendent party" jurisdiction, addressed by this

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jurisdiction invoked by Davis here. 692 F.2d at 556, n. 6.

court in Aldinger v. Howard, 427 U.S. 1, 96 S. Ct. 2413, 49 L. Ed.2d 276 (1976). App. p. 47. The court of appeals said it has treated the "pendent party" problem as a subset of ancillary jurisdiction, and required an independent jurisdictional basis for the assertion of jurisdiction over pendent parties, even though the additional parties are called upon to answer claims under the court's ancillary jurisdiction. App. p. 47. The court of appeals also said that this Court had not rejected its "cautious" approach to "pendent party" jurisdiction (i.e., requiring an independent basis for jurisdiction over pendent parties). But, certainly, this Court's opinion in Moor v. County of Alameda, supra, cast considerable doubt upon the validity of the ninth circuit's blanket rule that jurisdiction can never be exercised over pendent parties absent an independent jurisdictional basis.

But, whether that is true of not, this Court never approved the concept of requiring an independent basis for jurisdiction over parties joined under Rule 13(h) who are subject to the district court's ancillary jurisdiction, and certainly has not approved the court of appeals' contention that the "pendent party" problem is a subset of ancillary jurisdiction. See, Moor, at p. 714-715.

Although the court of appeals acknowledged there was an independent basis for exercise of jurisdiction (Davis' federal securities claims), the court of appeals said it could treat Davis, severed from plaintiffs Danners' claim of foreclosure, as a separate, "brand new" "plaintiff". App. p. 48-49.[26] The court of appeals then

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[26] The court of appeals relied on opinions which held, in unrelated contexts, that the filing of a third-party complaint "commenced" an action against the third party. See, e.g., United States v. Hawaii, 832 F.2d 1116, 1117 (9th Cir. 1987), and cases cited in opinion, App. p.

applied the same "pendent jurisdiction" analysis used by the district court, not only to Davis' state law claims against defendants Davis joined under Rule 13(h), but also to Davis' state law claims against Davis' co-defendants and upheld the trial court's dismissal.

This Court has not addressed the question of whether a district court has the discretion to dismiss cross-claims asserted under Rule 13(g) against co-defendants, or Rule 13(g) cross-claims asserted against defendants joined under Rule 13(h), upon the dismissal or settlement before trial of plaintiff's claims on other than jurisdictional grounds. Further, neither this Court, nor any other circuit court, has addressed the precise question here; that is, when cross-claims properly brought under Rule 13(g) are

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49-50.

severed for a separate trial, and plaintiff's claims proceed to trial, and plaintiff prevails, can defendant's severed cross-claims be thereafter dismissed? As the court of appeals noted, the fact that Davis' cross-claims were transferred to the California District Court pursuant to 28 U.S.C. § 1404, did not change anything. The result below is directly contrary to the express language of 13(i), which would seem to indicate that the district court should proceed to try the cross-claims so severed, if it has jurisdiction, regardless of the disposition of plaintiff's claim (as long as it was not dismissed on jurisdictional grounds). This issue presents an important question of federal law which has not been settled, but should be, and review is appropriate under Rule 17.1(c), Supreme Court Rules.

Even assuming the district court had discretion, the court of appeals' conclu-

sion that the district court did not abuse that discretion is erroneous. The case had been pending for over three years. Davis, an unwilling participant in the federal court proceeding, proceeded, as the federal rules contemplate, to bring all claims, and join all parties, arising out of the controversy which was the subject of plaintiff's claims. After extensive pleading, motions and discovery, including 34 depositions, and when the case was within months of trial, the court dismissed Davis' state claim claims, even though it had jurisdiction. This occurred two years after those claims had been severed for a separate trial, and nearly two years after plaintiff's claim had been tried. If that is not an abuse of discretion, this author cannot imagine what would be.

CONCLUSION

This court should grant the writ, reverse the decision of the district and circuit courts holding the note is not a security, and remand the case for trial. Alternatively, if the Court does not agree the note is a security, this Court should remand Davis' state law claims with instructions to the district court to try them.

Respectfully submitted,

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Gordon T. Carey, Jr.
Attorney for Petitioner Davis

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

ROBERT E. DANNER and CHARLOTTE DANNER, husband and wife, et al.,	No. CV 85-7661-RJK (Gx)
Plaintiffs,	
v.	MEMORANDUM OF DECISION AND ORDER
HENRY HIMMELFARB, and individual; CHARLOTTE HAYS, an individual; RICHARD A. EDWARDS, an individual, et al.,	[Filed May 5, 1987, U.S.D.C., C.D. Cal.]
Defendants.	
AND RELATED CROSS-ACTIONS.	

KELLEHER, ROBERT J.; JUDGE:

The following matters came on for hearing on May 4, 1987:

(1) Cross-defendant Himmelfarb's motion for summary judgment, joined in by cross-defendants GAGE, Kitchens and Miller;

(2) Cross-defendants GAGE, Kitchens and Miller's motion to dismiss Richard A.

Edwards' counter-claim and cross-claim for equitable indemnity and contribution;

(3) Cross-claimant Davis' motion to dismiss Edwards' counter-claim and cross-claim; and

(4) Cross-defendant Ronald Garrett's response to this Court's order to show cause why he should not be held in contempt for failure to appear at his duly noticed deposition in response to a subpoena.

Having fully considered these matters, the materials filed by the parties in connection therewith, and the files and records of the case, the Court now orders:

(1) Cross-defendant Himmelfarb's motion for summary judgment is GRANTED in its entirety;

(2) Cross-claimant Davis' federal securities law claims are hereby DISMISSED with prejudice;

(3) Cross-claimant Davis' remaining pendent state law claims are hereby DISMISSED without prejudice;

(4) The pending motions to dismiss cross-defendant Edwards' counter-claim and cross-claim for equitable indemnity and contribution are rendered moot; and

(5) The Court's April 7, 1987 Order to Show Cause is hereby VACATED as moot.

FACTS

Plaintiffs conveyed two parcels of property in Oregon to defendants Hays and Himmelfarb in 1981 in exchange for a deed of trust on one of the parcels. Hays and Himmelfarb conveyed to plaintiffs a security interest in property located in Laguna, California.

Defendant Hays and defendants and cross-defendants Himmelfarb, Edwards, Iseli, Kitchens and Miller are shareholders, directors or officers of cross-defendant Golden Arrow Gas Energy Corp. ("GAGE"). GAGE is an

Oklahoma corporation of which cross-defendant Empire Equities, Inc. ("Empire") is a subsidiary. Edwards, Hays, Miller, Kitchens and Stepp are officers and directors of Empire.

In June, 1982, defendants Hays and (sic) Himmelfarb conveyed another security interest in the Oregon property to an Oklahoma bank. Thereafter, defendants conveyed the property to GAGE, which in turn conveyed it to Empire in exchange for an 80 percent ownership share in Empire.

Late in 1982, Empire decided to pursue investment opportunities in Mexico. To finance the investment, it decided to obtain pesos and ran an advertisement in the Wall Street Journal soliciting pesos.

In November, 1982, cross-claimant Davis learned from his daughter, an Empire employee, that Empire was looking for pesos. Davis told his daughter that he might be interested in discussing the sale of pesos. Davis' daughter introduced him to Stepp, Hays

and Garrett, who offered Davis oil and gas leases in exchange for pesos. Davis declined this offer.

A number of terms were discussed and the parties ultimately agreed that Davis would transfer approximately $400,000.00 worth of pesos to Empire in exchange for a note for $400,000.00 secured by the Oregon real property. The note provided for the quarterly payment of interest to Davis at the prime rate plus one percent with the principal due in 48 months. The note included an acceleration upon default clause. Davis claims he was led to believe he was given a first lien on the Oregon property. However, Davis' lien was subordinate to plaintiff's lien and to the bank's lien.

Plaintiffs filed this action in February, 1984 against Hays, Himmelfarb, Empire, Davis, the bank, and others in the District Court of Oregon on the basis of diversity of citizenship. They sought to foreclose their

lien on the Oregon properties after defendants Hays and Himmelfarb defaulted on the payments. The court entered an order of foreclosure in August, 1985. The action was thereafter transferred to this Court.

Davis filed his initial answer and counter-claim against Himmelfarb, Hays, Edwards and Empire. With leave of Court, he later amended to add Stepp, Kitchens, and GAGE as cross-defendants. Davis' Second Amended Cross-Claim added Iseli, Miller and Ganant as cross-defendants. The Third Amended Cross-Claim added Robert Pike and Rutan & Tucker, a law firm. Davis' cross-complaint alleges causes of action for negligent and intentional misrepresentation, violation of federal and state securities fraud laws, and failure to register securities in violation of federal and state law against all cross-defendants. Additionally, the Third Amended Complaint alleges negligence against Pike and Rutan & Tucker.

Plaintiffs' claims against all parties have been resolved. Davis' cross-claims are all that remain in this action.

Cross-defendant Himmelfarb, joined by GAGE, Miller and Kitchens, now moves for summary judgment on the ground that Davis' allegation that his note secured by a trust deed on the Oregon property is a security must fail. Accordingly, cross-defendants argue, Davis cannot state a federal cause of action and the Court should decline to exercise pendent jurisdiction over the state law claims.

DISCUSSION

I. Definition of Security

For purposes of applying security regulations under the 1934 Securities Act, the Supreme Court includes within the definition of security "an investment of money in a common enterprise with profits to come solely from the efforts of others." SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946). Whether

a transaction falls within the ambit of the securities laws is to be determined by the "economic realities underlying a transaction, and not the name appended thereto." United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975).

In refining this imprecise standard, the Ninth Circuit has developed the "risk capital" approach, in which the critical question is whether there has been a contribution of risk capital subject to the entrepreneurial or managerial efforts of others. Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1256 (9th Cir. 1976). Six relevant factors, no one of which is dispositive, have been identified: (1) time; (2) collateralization; (3) form of the obligation; (4) circumstances of issuance; (5) relationship between the amount borrowed and the size of the borrower's business; and (6) contemplated use of the funds. Id. at 1217-1258.

The Court concludes that application of these factors to the transaction at issue indicates that it was intended to be a commercial loan rather than an investment of risk capital subject to the managerial efforts of others.

A. Time

The promissory note Davis received had a term of 48 months. Interest was to be paid quarterly at a rate of one percent above prime, and an acceleration upon default clause was included.

Davis cites Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985), for the proposition that a four year term suggests the transaction was a security. In Underhill, the Ninth Circuit upheld a finding that an investment package in which investors received notes of one to three years' duration was a security. The investor's funds were then used to purchase third party obligations secured by trust deeds. However, the transaction at

issue in Underhill was completely different than the one involved here. It consisted of

> representations to hundreds of investors of a prearranged plan to create a general fund for the purchase of notes secured by trust deeds. The logistics of the plan left very little to 'negotiation' and did not resemble a commercial lending transaction.

Id. at 1431.

In contrast, Davis' note was a privately negotiated transaction secured by real property. Uncontradicted testimony indicates Davis rejected other forms of structuring the deal. Particularly, Davis testified that he rejected an offer of an interest in the investment in Mexico because "I wasn't interested in the investment." Although four years is a relatively short term for a note secured by real property, the Court concludes that the duration of the note is not a significant factor in characterizing Davis' transaction with Empire.

B. Collateralization

A loan secured by real property will not ordinarily be found to be a security. MTG Corp. v. Arizona Mall of Tempe, 583 F.2d 426, 433 (9th Cir. 1978); United California Bank v. THC Financial Corp., 557 F.2d 1351 (9th Cir. 1979).

Davis' note was secured by a lien on the Oregon real property. However, defendants reserved the right to substitute any other real property as collateral. Davis argues that this right of substitution is unconsistent (sic) with a commercial loan transaction. Davis alternatively argues that the loan was not in fact collateralized because the lien defendants gave him was worthless.

The mere fact that Davis was deceived as to the priority of the lien does not make the transaction a security. However, defendants' right to substitute collateral renders the importance of collateralization of the loan insignificant for purposes of characterizing

the transaction. See Underhill v. Royal, 769 F.2d 1426, 1431 (9th Cir. 1985).

C. Form of the Obligation

In contrast to the transaction in Underhill, the obligation at issue appears to be a garden variety privately negotiated loan secured by real property. Although Davis now characterizes the transaction as a contribution of capital "subject to the risk of Empire's entrepreneurial efforts," in his deposition testimony he unambiguously disclaimed any interest in Empire's Mexico investment and affirmed that Empire's obligation to Davis had no relationship to Empire's success or failure in that venture.

D. Relationship Between Amount Borrowed and Size of Borrower's Business

The larger the amount borrowed in relation to the size of the borrower's business, the greater the lender's risk. Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1258 (9th Cir. 1976). Davis notes that at the

time he transferred the pesos to Empire, the corporation had a negative net worth. This fact supports a finding that Davis' risk was great in making the loan to Empire. However, it is important to distinguish between "risk capital" and a "risky loan." Id. at 1257. Davis' testimony at his deposition unequivocally establishes that he looked to the collateral to secure repayment, not to Empire's entrepreneurial efforts. He characterizes the transaction as follows: "I was selling them pesos; they were buying pesos in exchange for a note. And again, what they decided to do with those pesos was their business." It is clear that Davis viewed himself as a secured creditor who would be protected even if the business failed.

E. Contemplated Use of the Funds

As noted above, Davis' own testimony establishes that although he knew the pesos were to be used to invest in Mexico, he did

not view repayment of his note as dependent upon the success of the venture.

F. Circumstances of Issuance

"Whether the obligations were issued to a single party or to a large class of investors sheds light on the nature of the financing." Kotz, 532 F.2d at 1258 (citing McClure v. First Nat'l Bank of Lubbock, 497 F.2d 490 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975)). Davis claims that Empire's offer to buy pesos was part of a larger public offering. The only evidence Davis offers in support of this contention is that Empire advertised in the Wall Street Journal soliciting pesos and corresponded extensively with prospective sellers.

However, the circumstances surrounding Davis' deal with Empire belie any analogy to a public offering. Davis was put in contact with Empire through his daughter. Unlike the investors in Underhill, Davis conducted extensive negotiations and participated

actively in determining the structure of the transaction. Moreover, it was Davis who demanded that the note be secured by a lien on real property. Additional uncontroverted testimony suggests that the payment schedule on the note was set up to accommodate Davis' personal tax considerations.

The Court concludes that application of the risk capital factors to the undisputed facts of this case precludes a finding that the transaction at issue is a security. Accordingly, Davis' federal securities law claims must be dismissed with prejudice.

II. The Pendent State Claims

The moving parties next contend that the Court should dismiss the remaining state law causes of action in Davis' third amended cross-complaint. The procedural posture of this action renders the question of this Court's subject matter jurisdiction over the remaining claims somewhat complex. Plaintiffs, citizens of Oregon, brought this

action against certain of the defendants, all of whom were citizens of California, on the basis of diversity of citizenship. Davis first cross-claimed against his co-defendants, Himmelfarb, Hays, Edwards and Empire, alleging federal and state causes of action. Davis' second and third amended cross-complaints added new parties who had not been named in the original action.

Fed.R.Civ.P. 13(g) provides that:

> A pleading may state as a cross-claim any claim by one party against a co-party arising out of the transaction or occurrence that is the subject matter of the original action or of a counterclaim therein or relating to any property that is the subject matter of the original action. (emphasis added)

The Ninth Circuit has held that a cross-claim for fraud concerning property may properly be asserted when the original action is brought for foreclosure on the property. Lenske v. Knutsen, 410 F.2d 583, 586 (9th Cir. 1969). Such a cross-claim against a co-party is within the ancillary jurisdiction of

the federal courts and need not present an independent ground for subject matter jurisdiction. C. Wright and A. Miller, Federal Practice & Procedure: Civil § 1433, at 177. Accordingly, dismissal of Davis' federal claims does not deprive the Court of subject matter jurisdiction over Davis' state law cross-claims against Himmelfarb, Hays, Edwards and Empire, even though all are citizens of California. However, as is true for other claims of ancillary or pendent jurisdiction, the assertion of jurisdiction is discretionary. Id. § 1433 (Supp. 1986).

Nor does dismissal of Davis' federal law claims deprive the Court of subject matter jurisdiction over Davis' state law claims against all other parties. It is well-settled in this circuit that an independent ground for subject matter jurisdiction must exist over a third party defendant brought in under Fed.R.Civ.P. 13(h). Safeco Ins. Co. v. Guyton, 692 F.2d 551, 555 (9th Cir. 1982).

Davis' cross-claims against third party defendants brought into the action for the first time by Davis stated causes of action within this Court's federal question jurisdiction. Thus, an independent basis for subject matter jurisdiction over these parties existed and the Court had pendent jurisdiction over the state law claims against these parties.

Accordingly, the Court now has discretion to retain pendent jurisdiction over Davis' state law claims if considerations of judicial economy and fairness so dictate. Aydin Corp. v. Loral Corp., 718 F.2d 897, 903-04 (9th Cir. 1983).

Davis urges the Court to retain pendent jurisdiction because of the extensive discovery conducted and the costs incurred by the parties. However, the parties will not be required to conduct discovery all over again merely because the action is filed in state court.

Davis also contends that his action under state law may be barred by applicable statutes of limitations. However, Davis merely states that "Cross-defendants could arguably claim that all of Davis' claims are time-barred." Absent a clearer showing that Davis will be barred from litigating his claims in state court, the Court finds no reason to retain jurisdiction over the state causes of action.

The foregoing shall constitute the Court's findings of fact and conclusions of law.

The Clerk shall send, by United States mail, a copy of this Memorandum of Decision and Order to counsel for the parties.

DATED: May 4, 1987.

/s/ROBERT J. KELLEHER
Senior District Judge

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

ROBERT E. DANNER and CHARLOTTE DANNER, husband and wife, et al.,	No. CV 85-7661-RJK (Gx)
Plaintiffs,	
v.	JUDGMENT
HENRY HIMMELFARB, and individual; CHARLOTTE HAYS, an individual; RICHARD A. EDWARDS, an individual, et al.,	[Filed May 15, 1987, U.S.D.C., C.D. Cal.]
Defendants.	
AND RELATED CROSS-ACTIONS.	

This matter came on for hearing on May 4, 1987. Having fully considered the issues and rendered a decision by Memorandum of Decision and Order filed May 5, 1987,

IT IS HEREBY ORDERED AND ADJUDGED that cross-complainant Davis take nothing on his cross-claims, that his federal securities law claims be dismissed on the merits, and that

his pendent state law claims be dismissed without prejudice.

IT IS FURTHER ORDERED that all parties shall bear their own costs of suit.

The Clerk shall send, by United States mail, a copy of this Judgment to counsel for the parties.

DATED: May 15, 1987.

/s/ROBERT J. KELLEHER
Senior District Judge

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ROBERT E. DANNER; CHARLOTTE DANNER; GADAN, INC.	)	No. 87-6021
Plaintiffs,	)	
v.	)	
HENRY HIMMELFARB, CHARLES T. HAYS; RICHARD A. EDWARDS; GOLDEN ARROW GAS ENERGY CORPORATION; JIM KITCHENS; RONALD G. MILLER; THOMAS E. STEPP; RUTAN & TUCKER; ROBERT PIKE; EMPIRE EQUITIES; RONALD GARRETT; ANDRE ISELI,	)	OPINION
Defendants/Cross-Claimant/defendants Appellees,	)	
VINCENT E. DAVIS,	)	
Defendant/Cross-claimant/Appellant.	)	

Argued and Submitted
April 6, 1988-Pasadena, California

Decided and Filed September 28, 1988

Before: Melvin Brunetti, Alex Kozinski and David R. Thompson, Circuit Judges

Reported at 858 F.2d 515

OPINION

THOMPSON, Circuit Judge:

The district court granted summary judgment against Vincent E. Davis on his federal securities law claim and dismissed his state law claims against Henry Himmelfarb, Charles T. Hays, Richard A. Edwards, Golden Arrow Gas Energy Corp. ("GAGE"), Jim Kitchens, Ronald G. Miller, Thomas E. Stepp, the law firm of Rutan & Tucker, Robert Pike, Empire Equities ("Empire") and Ronald Garrett. The district court concluded that Empire's promissory note given to Davis in exchange for $400,000 worth of pesos[1] was not a "security" within the meaning of the federal securities laws.

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[1] In his reply brief, Davis explains that he is acting on behalf of himself and two other individuals, Messrs. Austin and Funckey. Each of these three individuals had pesos on deposit at Banamex, a Mexican bank. Austin and Funckey assigned their certificates of deposit to Davis so that he might represent them during the negotiations with Empire Equities.

Davis argues that summary judgment on his securities law claim was inappropriate because there are disputed issues of material fact. In the alternative, Davis would have us hold that even if Empire's promissory note is not a "security," the district court nonetheless abused its discretion by dismissing his state law claims after almost 3 years of discovery and pretrial maneuvering.

We have jurisdiction of this appeal under 28 U.S.C. § 1291, and we affirm.

I

Standard of Review

We review de novo a grant of summary judgment. Lamothe v. Atlantic Recording Corp., 847 F.2d 1403, 1404 (9th Cir. 1988). Viewing the evidence and its inferences in the light most favorable to the nonmoving party, summary judgment is proper if the movant is clearly entitled to prevail as a matter of law. Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 586-87

(1986); Lamothe, 847 F.2d at 1404. "The moving party is entitled to judgment as a matter of law [when] the nonmoving party has failed to make a sufficient showing on an essential element of her case with respect to which she has the burden of proof." Celotex Corp. v. Catrett, 477 U.S. 317, 323 (1986). That is, summary judgment is appropriate "[w]here the record taken as a whole could not lead a rational trier of fact to find for the nonmoving party." Matsushita, 475 U.S. at 587.

II

Facts and Proceedings

The appeal before us arises out of several transactions that began in 1981. In that year, the plaintiffs (who are no longer parties to this action) conveyed two pieces of real property to Hays and Himmelfarb in exchange for a promissory note secured by a deed of trust on a parcel of Oregon real property. Hays and Himmelfarb later granted

a second deed of trust on this property to an Oklahoma bank.

Hays and Himmelfarb then sold the Oregon property to Golden Arrow Gas Energy Corp. (GAGE), which in turn sold the property to Empire Equities for an 80% ownership interest in Empire. After this transaction, Empire became a GAGE-subsidiary. Hays, Himmelfarb, and cross-defendants Edwards, Iseli, Kitchens and Miller are shareholders, officers and directors of GAGE. Edwards, Hays, Miller, Kitchens and Stepp are also officers and directors of Empire.

In 1982, Empire decided to pursue some investment opportunities in Mexico. To fund a proposed real estate development, Empire placed an advertisement in the Wall Street Journal soliciting pesos. One of Empire's employees told her father, Vincent E. Davis, that Empire was interested in acquiring pesos. Davis had $400,000 worth of pesos in Mexico which he could not bring out of the

country because of recently imposed currency control restrictions. Davis asked his daughter to arrange a meeting for him with Empire's officers.

In November 1982, Davis met with Stepp, Hays and Garrett, who are Empire officers. They offered Davis oil and gas mineral interests in exchange for his pesos. Davis declined this offer, as he later declined the opportunity to exchange his pesos for a share of the profits from the Mexican venture. Davis eventually negotiated to receive from Empire, in exchange for his pesos, a promissory note in the principal sum of $400,000, payable in United States currency, with quarterly interest to be paid at an annual rate of prime plus 1%, with interest payments to commence in June 1984. Davis insisted that the note be secured by a first lien deed of trust. Empire agreed and granted Davis a lien on the Oregon property. Davis did not realize that this lien was subordinate to the

liens of the plaintiffs and the Oklahoma bank.

In February 1984, Hays and Himmelfarb defaulted on the note they had given to the plaintiffs (the Danners and Gadan, Inc.) in connection with the original land transaction. The plaintiffs filed a suit to foreclose their deed of trust on the Oregon property. This suit was commenced in the United States District Court for the District of Oregon and Davis was named as a defendant. Davis answered the plaintiff's complaint and cross-claimed against his co-defendants Hays, Himmelfarb, Edwards and Empire. He alleged a federal securities law claim for fraud, as well as several state law claims. The court severed Davis's cross-claims for a separate trial. Himmelfarb moved for a transfer of the cross-claims to California. Before the court granted this motion, Davis amended his cross-claim to join Stepp, Kitchens and GAGE as additional cross-defendants under Federal

Rule of Civil Procedure 13(h); these cross-defendants were not parties to the original action. The court then transferred Davis's severed cross-claims to the United States District Court for the Central District of California.

After the transfer, Davis filed second and third amended pleadings in which he joined Iseli, Miller, Garrett, Rutan & Tucker, and Pike, as cross-defendants. Davis's cross-claim alleges causes of action against all cross-defendants for negligent and intentional misrepresentation, violation of state and federal securities antifraud provisions, and failure to register securities under federal and state law. Davis also alleged claims for negligence against Rutan & Tucker and Pike.

In the meantime, the district court in Oregon resolved the foreclosure action in favor of the plaintiffs; the plaintiffs have no further interest or role in this action.

In the proceedings on the cross-claims, Himmelfarb, Miller, GAGE and Kitchens moved for summary judgment on the ground that the Empire note is not a "security" and therefore there is no federal securities law subject matter jurisdiction. The district court granted the motion for summary judgment. It then dismissed Davis's state law claims. Davis appeals.

III

Analysis

A. Empire's Note Is Not a Security

We confront one of the most vexatious questions raised by the federal securities laws: When is a "note" a "security"? Both the Securities Act of 1933 and the Securities Exchange Act of 1934 define the term "security" to include any "note," "unless the context otherwise requires." See 15 U.S.C. § 77b(1) (section 2(1) of the 1933 Act); id. § 78c(a)(10) (section 3(a)(10) of the 1934 Act). Notwithstanding slight differences

between the definitions in the 1933 and 1934 Acts, the Supreme Court has said that "the definitions of 'security' in [the Acts] are virtually identical and will be treated as such in...decisions dealing with the scope of the term." Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 n.1 (1985); see also Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (same); United Cal. Bank v. THC Fin. Corp., 557 F.2d 1351, 1356 (9th Cir. 1977) ("The two definitions...are considered functional equivalents.").

[1] In exploring the boundaries of the term "security," the Court has eschewed a literal approach, focusing instead on the economic realities of the underlying transaction. See, e.g., Tcherepnin, 389 U.S. at 336 ("[W]e are reminded that, in searching for the meaning and scope of the word 'security' in the [1934] Act, form should be disregarded for substance and the emphasis should be on economic reality."). Moreover, the context

of the transaction sought to be placed within the scope of the securities laws is relevant to deciding whether some financial instrument is a "security." Landreth, 471 U.S. at 687; United Sportfishers v. Buffo, 597 F.2d 658, 660 (9th Cir. 1978).

[2] In applying the "economic realities" approach, we are guided by the Supreme Court's three-pronged test for "investment contracts": "There must be (1) an investment of money, in (2) a common enterprise and (3) an expectation of profits from the managerial efforts of others." United Cal. Bank, 557 F.2d at 1358 (paraphrasing the test of SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946)). Focusing on the "'economic realities' standard plus the Court's emphasis of an expectation of profits from the entrepreneurial efforts of others," id., this circuit has developed the so-called "risk capital"

test to determine when a note transaction involves a "security." Id.[2]

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[2] In Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985), the Court departed from its typical "economic realities" approach and used a "literal" interpretation of the federal securities laws to find that the sale of 100% of a corporation's common stock was the sale of a "security" within the meaning of the securities laws. The Court explained:

> As we...recognized in [United Housing Found., Inc. v. Forman, 421 U.S. 837 (1975)], the fact that instruments bear the label "stock" is not itself sufficient to invoke the coverage of the Acts. Rather, we concluded that we must also determine whether those instruments possess "some of the significant characteristics typically associated with" stock, recognizing that when an instrument is both called "stock" and bears stock's unusual characteristics, "a purchaser justifiably [may] assume that the federal securities laws apply."

Id. at 686 (citations omitted; brackets added in part).

The Court's decision to rely on the characteristics of an instrument denominated "stock" to find coverage by the federal securities laws also found support in the "context of the transaction...--the sale of stock in a corporation--[which] is typical of the kind of context to which the Act normally applies." Id. at 687. Thus, the Court's approach in Landreth does not require us to ignore the economic realities and the context

We applied the "risk capital" test to a note transaction in Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1255 (9th Cir. 1976). We explained in Kotz that by emphasizing the economic realities underlying a specific transaction, the Court has made it clear that not every transaction involving a "note" necessarily involves a "security." Id. at 1256. As a result, the courts of appeals have tried to distinguish between "commercial" transactions, which do not involve "securities," and "investment" transactions, which do. Id. at 1257. We have also quoted the Seventh Circuit's observation that

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of the underlying transaction in declining to label Empire's note to Davis as a "security." Indeed, the Court in Landreth said that it would "expressly leave until another day the question whether 'notes' or 'bonds' or some other category of instrument listed in the definition might be shown 'by proving [only] the document itself.'" Id. at 694 (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 355 (1943)).

> [i]n one sense every lender of money is an investor since he places his money at risk in anticipation of a profit in the form of interest. Also in a broad sense every investor lends his money to a borrower who uses it for a price and is expected to return it one day.

Id. (quoting C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc., 508 F.2d 1354, 1359 (7th Cir.), cert. denied, 423 U.S. 825 (1975)). We developed the "risk capital" test to help us "distinguish between the 'risky loan' and 'risk capital.'" Id.

"Under the risk capital standard the ultimate question is whether the funding party contributed risk capital subject to the entrepreneurial or managerial efforts of others." United Cal. Bank, 557 F.2d at 1358 (internal quotation marks and brackets omitted; quoting Kotz, 532 F.2d at 1257). Our "risk capital" analysis generally requires us to apply a non-exclusive six-factor test in order to "analyze the nature and degree of risk accompanying the transaction to the

party providing the funds." Kotz, 532 F.2d at 1256.[3] We have applied these factors in several cases involving note transactions. See, e.g., Underhill v. Royal, 769 F.2d 1426, 1431 (9th Cir. 1985); AMFAC Mortgage Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426, 432-34 (9th Cir. 1978); United Cal. Bank v. THC Fin. Corp., 557 F.2d 1351, 1358-59 (9th Cir. 1977). We also have applied the "risk capital" test to the sale of fractional

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[3] The six factors identified in Kotz are (1) length of time the funds are at risk; (2) collateralization; (3) form of the obligation; (4) circumstances of the issuance; (5) relationship between the amount borrowed and the size of the borrower's business; and (6) contemplated use of the funds. Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1257-58 (9th Cir. 1976). In Kotz, we rejected as relevant criteria the negotiability of the instrument and the transaction impetus. Id. at 1258 n. 5. We have emphasized that our list is not exhaustive, that none of the factors is by itself dispositive, id. at 1258, and that it is the combined effect of the factors that determines whether the funding party has advanced "risk capital" or simply made a "risky loan." Id.; see also Underhill v. Royal, 769 F.2d 1426, 1431 (9th Cir. 1985); Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426, 432 (9th Cir. 1978).

undivided oil and gas mineral interests. E.g., Simon Oil Co. v. Norman, 789 F.2d 780, 782 (9th Cir. 1986). But in each of these cases, the question whether the instrument constituted a "security" was a close one, requiring us to decide if the extension of funds was a "risky loan" or an investment of "risk capital," see, e.g., Underhill, 769 F.2d at 1431; or whether what was undoubtedly an "investment" was subject to the risks associated with leaving money to the entrepreneurial or managerial control of others, see, e.g., Simon Oil, 789 F.2d at 782. We have not applied the "risk capital" test when the context of the underlying transaction is such that it is clear that no "security" is involved. See United Sportfishers v. Buffo, 597 F.2d 658 (9th Cir. 1978).

At the outset, we note that "the nature of an instrument is to be determined at the time of issuance, not at some subsequent time." West v. Multibanco Comermex, S.A.,

807 F.2d 820, 826 (9th Cir.) (quoting Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1255 (9th Cir. 1976)), cert. denied, 107 S. Ct. 2483 (1987). In the present case, because of recently imposed currency control laws, Vincent Davis had a substantial sum of money trapped in Mexico. Davis wanted to get his money out of Mexico. Through his daughter, an Empire Equities employee, Davis learned that Empire wanted to purchase pesos. Davis asked his daughter to arrange a meeting between him and Empire to discuss selling his pesos. When Davis and Empire's officers met, Davis offered to sell Empire his pesos. Empire offered to exchange the pesos for oil and gas mineral interests. Davis declined the offer, as he later declined Empire's offer to advance the pesos against a share of the profits to be derived from Empire's contemplated Mexican development venture. Instead, Davis offered to sell his pesos in exchange for a promissory note secured by a

deed of trust on real property. Davis negotiated a note that paid him $400,000 in United States currency at the end of a four-year term. Quarterly interest payments were scheduled to begin 1 1/2 years after the date of the note. Indeed, it was in response to Davis's tax-planning considerations that Empire agreed to defer payment of quarterly interest. Davis demanded his note be secured by a first deed of trust on real property. The deed of trust he received was not a first lien on the property. Perhaps Davis was defrauded. But fraud alone does not implicate the anti-fraud provisions of the federal securities laws. Marine Bank v. Weaver, 455 U.S. 551, 556 (1982); Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1253 (9th Cir. 1976).

[3] Like the plaintiff in Buffo, Davis sold an asset in exchange for a promissory note secured by a deed of trust. Davis did not "invest" his money in Empire or in

Empire's planned Mexican venture. He did not expect "profits" in the sense of either capital appreciation or a share of the earnings from a business venture formed with the borrowed capital. See Buffo, 597 F.2d at 660 (discussing the Supreme Court's definition of "profits" in United Housing Found., Inc. v. Forman, 421 U.S. 837, 852 (1975)). Davis did not "lend" Empire money, except to the extent that any sale of an asset in exchange for a promissory note represents the seller's loan to the buyer of a portion of the purchase price. Based on the context of the transaction and its economic realities, we agree with the district court that Empire's note is not a "security" for purposes of the federal securities law. Summary judgment was proper.

B. Dismissal of Davis's State Claims

Davis contends that the district court in California lacked power to dismiss his state law claims, either because the transfer of his claims to it left it without power to

do anything other than hear the entire case or because it lacked power to dismiss once the transferor court in Oregon resolved the original foreclosure action. Davis also argues that even if the district court in California had power to dismiss his claims, it abused its discretion because it treated his state claims as pendent to his federal claim, rather than viewing all his claims as ancillary to the original foreclosure action.

1. Transfer of the Case

[4] Before the federal district court in Oregon resolved the original foreclosure action, that court granted a motion under 28 U.S.C. § 1404(a) to transfer trial of Davis's cross-claim to another proper venue for convenience of witnesses. Davis does not contend that the transfer of the case from the District of Oregon to the Central District of California was improper. Rather, Davis asserted at oral argument that the transfer, in and of itself, rendered the

transferee court without power to dismiss the action.

Although discussed in only a handful of cases and considered but briefly in the literature, the answer to this argument is fairly obvious: "[W]hen an action is transferred, it remains what it was; all further proceedings in it are merely referred to another tribunal, leaving untouched what has been already done." Magnetic Eng'g & Mfg. Co. v. Dings Mfg. Co., 178 F.2d 866, 868 (2d Cir. 1950); see also Landwehr v. United States (In re Miller), 485 F.2d 74, 76 (5th Cir. 1973) (applying Magnetic Engineering in bankruptcy context), cert. denied, 415 U.S. 990 (1974); Ginsburg v. Mutual Life Ins. Co., 170 F. Supp. 212, 214 (S.D.N.Y. 1958), aff'd, 263 F.2d 608 (2d Cir.), cert. denied, 360 U.S. 917 (1959); 15 C. Wright, A. Miller & E. Cooper, Federal Practice and Procedure: Jurisdiction 2d § 3846, at 362 & n.16

(collecting cases). As the Judicial Panel on Multi-District Litigation has observed:

> On change of venue the overwhelming authority holds that the jurisdiction and powers of the transferee court are coextensive with that of the transferor court; that the transferee court may make any order to render any judgment that might have been rendered by the transferor court in the absence of transfer.

In re Plumbing Fixture Cases, 298 F. Supp. 484, 495 (J.P.M.D.L. 1968) (citations omitted); accord In re Yarn Processing Patent Validity Litig., 472 F. Supp. 174, 177 (S.D. Fla. 1979) (following Plumbing Fixture); In re Upjohn Co. Antibiotic Cleocin Prods. Liab. Litig., 81 F.R.D. 482, 487 (E.D. Mich. 1979) (same), aff'd, 664 F.2d 114 (6th Cir. 1981).

2. Pendent Claims and Ancillary Jurisdiction

Davis alleges that the district court erred in dismissing his state law claims when it treated these claims as pendent to his federal securities law cross-claim. He

contends his state law claims should have been treated not as pendent claims, but as claims within the ancillary jurisdiction of the district court. Before answering Davis's argument, however, we emphasize that our first task is to distinguish between the court's jurisdiction over the claims joined by Davis under Rule 13(g) and its jurisdiction over the parties added under Rule 13(h) to defend against those claims. In the abstract, we agree with Davis's definition of "pendent claims" and "ancillary jurisdiction." We have explained that "[p]endent claims are state claims which arise from the same 'nucleus of operative facts' as that of a federal claim and which are joined in the same complaint with the federally cognizable claim by the original plaintiffs against the original defendants." Blake v. Pallan, 554 F.2d 947, 956-57 n.11 (9th Cir. 1977). We also have observed that "[ancillary] jurisdiction typically involves claims by a

defending party brought into court against its will, or by another person whose rights might be irretrievably lost unless [he or] she could insert them in an ongoing federal action." Redding Ford v. California State Bd. of Equalization, 722 F.2d 496, 498 (9th Cir. 1983) (citing Owen Equip. & Erection Co. v. Kroger, 437 U.S. 365, 376 (1978)), cert. denied, 469 U.S. 817 (1984).

[5] By these definitions, Davis's cross-claims fall within the "ancillary jurisdiction" of the district court. This is consistent with the conclusions reached by other courts faced with the same problem. See 6 C. Wright & A. Miller, Federal Practice & Procedure: Civil § 1433, at 177 & n.33 (1977) (collecting cases in support of the statement that "[i]t has generally been held that cross-claims under Rule 13(g) fall within the ancillary jurisdiction of the court and need not present independent jurisdictional grounds of federal jurisdiction.").

The rationale for ancillary jurisdiction is simple: Because the court already has jurisdiction over the main claim between the plaintiff and defendants, convenience, economy and fairness dictate that it should be able to resolve all other claims arising out of the same transaction or occurrence, or that relate to the property that is the subject matter of the principal action. See Aldinger v. Howard, 427 U.S. 1, 9-12, 11 n.7 (1976); see also Glens Falls Indem. Co. v. United States, 229 F.2d 370, 373-74, 373 n.1 (9th Cir. 1956). These same principles, of course, also underlie the doctrine of pendent jurisdiction, which permits the district court to resolve all claims asserted by the plaintiff which arise out of the same core of operative facts that form the basis of the action over which the federal court already has jurisdiction. See Aldinger, 427 U.S. at 9 (discussing United Mine Workers v. Gibbs, 383 U.S. 715, 725-27 (1966)).

[6] Davis's joinder of additional cross-defendants under Rule 13(h), however, raises a problem of "pendent party jurisdiction," which the Court first addressed in Aldinger v. Howard, 427 U.S. 1 (1976). We have treated the "pendent party" issue as a subset of ancillary jurisdiction. E.g., Libby, McNeill, & Libby v. City Nat'l Bank, 592 F.2d 504, 510 (9th Cir. 1978) ("Nor is jurisdiction over these two suppliers' claims saved by some type of ancillary or, more properly, pendent party jurisdiction."). We require an independent jurisdictional basis for the assertion of federal jurisdiction over pendent parties, even though the additional parties are called upon to answer claims within the court's ancillary jurisdiction. E.g., Safeco Ins. Co. of America v. Guyton, 692 F.2d 551, 555 & n.5 (9th Cir. 1982). Even though our approach is at odds with that of some of the other circuits, see, e.g., Moor v. County of Alameda, 411 U.S.

693, 713 n.29 (listing cases) (1973), as well as commentators' analyses, see, e.g., 6 C. Wright & A. Miller, supra, § 1436, at 191-92, the Supreme Court has not rejected our cautious approach to "pendent party" jurisdiction. Indeed, the Court has said that "[w]hether there exists judicial power to hear the state law claims against [a pendent party over whom there is no independent basis of federal jurisdiction] is . . . a subtle and complex question with far-reaching implications." Moor, 411 U.S. at 715. In the present case, we need not decide whether our "pendent party" cases require reevaluation. Davis's cross-claim included a federal securities law claim. Because there was an independent basis for the exercise of federal jurisdiction over the parties joined under Rule 13(h), the court had power to decide the state law claims asserted against them.

[7] It is also possible, however, to treat Davis's cross-claims and joinder of

additional parties solely as a matter of pendent jurisdiction. Looking at the unique procedural setting of this case, we see that before trial of the original foreclosure action, the court severed Davis's cross-claims for a separate trial. The court used Rule 42(b) to accomplish this result.

> The court, in furtherance of convenience or to avoid prejudice, or when separate trials will be conducive to expedition and economy, may order a separate trial of any claim, cross-claim, counterclaim, or third-party claim . . . .

Fed. R. Civ. P. 42(b). Consequently, we may view Davis as the plaintiff for purposes of the separate trial on his cross-claim. Cf. United States v. Hawaii, 832 F.2d 1116, 1117 & n.1 (9th Cir. 1987) (per curiam) (treating third-party complaint as "commencing" an action for purposes of 28 U.S.C. § 1345); United States v. City of Twin Falls, 806 F.2d 862, 867 (9th Cir. 1986) (treating third-party complaint under Fed. R. Civ. P. 14(a) as an "original" complaint for purposes of

ancillary jurisdiction), cert. denied, 107 S. Ct. 3185 (1987); American Nat'l Bank & Trust Co. v. Bailey, 750 F.2d 577, 582 (7th Cir. 1984) (stating in dicta that "maybe the cross-claim should be treated as if it had been a complaint that kicked off a brand-new suit" for purposes of establishing jurisdiction over a cross-claim under Rule 13(g)), cert. denied, 471 U.S. 1100 (1985). If Davis is treated as an original plaintiff, then his state law claims, which arise out of the same core of operative facts as his federal securities claim, are pendent claims within the meaning of United Mine Workers v. Gibbs, 383 U.S. 715, 725 (1966). Whether we treat Davis's severed cross-claims as a new action or not, in the present case, the court had jurisdiction over all the claims and each of the parties.

We do not find it necessary in this case to decide "whether there are any 'principled' differences between pendent and ancillary

jurisdiction." Owen Equipment, 437 U.S. at 370 n.8 (quoting Aldinger v. Howard, 427 U.S. 1, 13 (1976)); cf. id. at 370 ("[Pendent and ancillary jurisdiction] are two species of the same generic problem: Under what circumstances may a federal court hear and decide a state-law claim arising between citizens of the same State?"); Blake v. Pallan, 554 F.2d 947, 957 n.11 (9th Cir. 1977) ("Pendent jurisdiction is a specialized application of the ancillary jurisdiction is a specialized application of the ancillary jurisdiction concept." (citation omitted)). Whether Davis's state law claims are pendent to his federal cross-claim or are ancillary to the original action is irrelevant because, viewed either way, identical considerations lead us to conclude that the court did not abuse its "broad discretion" by dismissing the state law claims. E.g., Moor, 411 U.S. at 716. As we have said, "ancillary jurisdiction, like pendent jurisdiction, is a 'doctrine of

discretion . . . .'" City of Twin Falls, 806 F.2d at 868 (quoting Blake v. Pallan, 554 F.2d 947, 958 (9th Cir. 1977)).

The Supreme Court has told us that

> [pendent jurisdiction's] justification lies in considerations of judicial economy, convenience and fairness to litigants; if these are not present a federal court should hesitate to exercise jurisdiction over state claims, even though bound to apply state law to them. Needless decisions of state law should be avoided both as a matter of comity and to promote justice between the parties, by procuring for them a surer-footed reading of applicable law. Certainly, if the federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well.

United Mine Workers v. Gibbs, 383 U.S. at 726 (citation and footnotes omitted). We have also said that "ancillary jurisdiction" finds its justification in these same considerations. See City of Twin Falls, 806 F.2d at 868; Blake, 554 F.2d at 958; see also Glens Falls Indem. Co. v. United States, 229 F.2d 370, 373 (9th Cir. 1956) ("Ancillary claims

may be entertained to prevent the relitigation in other courts of the issues heard and adjudged in the original suit." (internal quotation marks and citation omitted)). Moreover, the Court itself has emphasized that the decision to exercise ancillary jurisdiction rests on notions of judicial economy and convenience to the parties. E.g., Owen Equipment, 437 U.S. at 377. Ancillary jurisdiction also rests on the common sense notion that if the court has jurisdiction over the principal claim, it may also adjudicate claims arising out of the same transaction or that relate to the property which is the subject of the primary dispute, see, e.g., Aldinger, 427 U.S. at 11.

Applying the Court's decision in United Mine Workers v. Gibbs, 383 U.S. 715 (1966), it is our practice to dismiss state law claims once the federal claim has been resolved. See, e.g., Durham v. Kelly, 810

F.2d 1500, 1506 (9th Cir. 1987) ("Where the district court has properly dismissed federal law claims 'pendent state claims also should be dismissed.'" (citing Gibbs)); City of Whittier v. United States Dept. of Justice, 598 F.2d 561, 564 (9th Cir. 1979) ("Dismissal of the federal claim before trial warranted dismissal of the City's state law claim as well."); Hodge v. Mountain States Tel. & Tel. Co., 555 F.2d 254, 261 (9th Cir. 1977) ("When a district court dismisses all federal claims prior to trial, it should not retain jurisdiction over pendent state claims."); accord United States v. Zima, 766 F.2d 1153, 1158 (7th Cir. 1985) (collecting cases in support of the statement, "The federal appeals courts in general . . . have indicated a strong preference for the dismissal of pendent or ancillary claims whenever the district court disposes of the federal claims prior to trial").

[8] As we understand Davis' argument, he contends the district court abused its discretion because it dismissed his state claims after 3 1/2 years of discovery and pretrial wrangling. Davis complains that he has been forced to refile his action in California state court and that he fears it will be several years before his claims are set for trial. Although we sympathize with Mr. Davis's frustration, his arguments do not show an abuse of discretion by the district court. In its United Mine Workers decision, the Court considered many of the contentions implicit in Davis's argument:

> The question of power [to decide pendent state claims] will ordinarily be resolved on the pleadings. But the issue whether pendent jurisdiction has been properly assumed is one which remains open throughout the litigation. Pretrial procedures or even the trial itself may reveal a substantial hegemony of state law claims, or likelihood of jury confusion, which could not have been anticipated at the pleading stage. Although it will of course be appropriate to take account in this circumstance of the already completed course of

> the litigation, dismissal of the state claim might even then be merited . . . . [R]ecognition of a federal court's wide latitude to decide ancillary questions of state law does not imply that it must tolerate a litigant's effort to impose upon it what is in effect only a state law case. Once it appears that a state claim constitutes the real body of a case, to which the federal claim is only an appendage, the state claim may fairly be dismissed.

United Mine Workers v. Gibbs, 383 U.S. 715, 727 (1966). Thus, while the passage of time is one factor favoring Davis's argument, it is by no means determinative.

> [A] federal court should consider and weigh in each case, and at every stage of the litigation, the values of judicial economy, convenience, fairness, and comity in order to decide whether to exercise jurisdiction over a case brought in that court involving pendent state-law claims. When the balance of these factors indicates that a case properly belongs in state court, as when the federal-law claims have dropped out of the lawsuit in its early stages and only state-law claims remain, the federal court should decline the exercise of jurisdiction by dismissing the case without prejudice.

Carnegie-Mellon Univ. v. Cohill, 108 S. Ct. 614, 618-19 (1988) (citations and footnote omitted); see also United States v. Zima, 766 F.2d 153, 1158 (7th Cir. 1985) ("After dismissal of federal claims, the district court must focus on factors such as judicial economy, fairness (particularly the prejudicial passage of state limitations periods) and convenience to the litigants, and the novelty or difficulty of the state law issues involved to determine whether to retain ancillary jurisdiction.").

Davis does not contend that his claims are time barred and that the policy of "fairness" therefore favors the exercise of jurisdiction by the district court. Davis simply asserts that it is inconvenient for him to have to refile in state court. But, as the Seventh Circuit has said, "Having to bring parallel suits may be a hardship, but it is not an injustice." Hartford Accident & Indem. Co. v. Sullivan, 846 F.2d 377, 381

(7th Cir. 1988). Davis does not dispute, nor could he, that principles of comity will be well-served by allowing the state courts to resolve claims solely of state law. It is true, of course, that in some of our cases we have said that because of lengthy pretrial proceedings, it was not an abuse of discretion to retain jurisdiction over state claims after the federal claim has been dismissed. See, e.g., Phelps v. Continental Ill. Nat'l Bank & Trust Co. (In re Nucorp Energy Sec. Litig.), 772 F.2d 1486, 1491 (9th Cir. 1985); Aydin Corp. v. Loral Corp., 718 F.2d 897, 904 (9th Cir. 1983). These cases, however, do not hold that the district court must exercise jurisdiction over pendent state claims whenever there have been lengthy pretrial proceedings. The decision to exercise jurisdiction is discretionary. The court in this case identified the relevant factors: "[T]he court . . . has discretion to retain pendent jurisdiction over Davis' state law claims if

considerations of judicial economy and fairness so dictate." The court balanced these factors, exercised its discretion, and declined to retain the state claims. We are not left with "a firm and definite conviction that the court below committed a clear error of judgment in the conclusion it reached upon a weighing of the relevant factors," United States v. Schlette, 842 F.2d 1574, 1577 (9th Cir. 1988) (citation omitted). Accordingly, we conclude the district court did not abuse its discretion in dismissing the state claims.

AFFIRMED.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

ROBERT E. DANNER; CHARLOTTE DANNER; GADAN, INC.	)	No. 87-6021
Plaintiffs,	)	D.C. No. CV 85-7661-RJK
v.	)	
HENRY HIMMELFARB, CHARLES T. HAYS; RICHARD A. EDWARDS; GOLDEN ARROW GAS ENERGY CORPORATION; JIM KITCHENS; RONALD G. MILLER; THOMAS E. STEPP; RUTAN & TUCKER; ROBERT PIKE; EMPIRE EQUITIES; RONALD GARRETT; ANDRE ISELI,	)	ORDER DENYING PETITION FOR REHEARING AND REJECTING SUGGESTION FOR REHEARING EN BANC
Defendants/Cross-Claimant/defendants Appellees,	)	[Filed December 15, 1988, U.S. Ct. of App., Ninth Circuit]
VINCENT E. DAVIS,	)	
Defendant/Cross-claimant/Appellant.	)	

Before: BRUNETTI, KOZINSKI and THOMPSON, Circuit Judges

The panel, as constituted above, has unanimously voted to deny the petition for

rehearing and to reject the suggestion for a rehearing en banc.

The full court has been advised of the suggestion for en banc rehearing and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is DENIED, and the suggestion for a rehearing en banc is REJECTED.

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NO. 88-1554

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1988

VINCENT E. DAVIS, Petitioner,

v.

HENRY HIMMELFARB; CHARLES T. HAYS; RICHARD A. EDWARDS; GOLDEN ARROW GAS ENERGY CORPORATION; JIM KITCHENS; RONALD G. MILLER; RUTAN & TUCKER; ROBERT PIKE; EMPIRE EQUITIES; RONALD GARRETT, Respondents.

ON WRIT OF CERTIORARI TO
THE COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Is A Single Promissory Note Secured by a Deed of Trust on a Parcel of Real Property a "Security"?

Where a party (Davis) is the owner of Mexican pesos located in Mexico and discovers through his daughter, who is an employee of a corporation, that the corporation seeks to purchase Mexican pesos; and where Davis negotiates one-on-one with the corporation, leading to a unique agreement whereby the corporation purchases from Davis $400,000 worth of pesos in exchange for a promissory note with a term of four years, secured by a deed of trust on a parcel of real property in Oregon; and where, during the negotiations, Davis declines to invest in the corporation's Mexican ventures and expresses no interest in what the corporation intends to do with the pesos; and where Davis alleges that the deed of trust he received was worth-

less because it was in third position rather than first position on the real property as the corporation had promised him; does the note, with its accompanying deed of trust, constitute a "security" as defined in the Securities Act of 1933 and the Securities Exchange Act of 1934?

2. May a District Court Dismiss Related State Law Claims After Dismissing All Federal Law Claims?

Where, in an action brought in the U.S. District Court in Oregon to foreclose on a parcel of property, one of the defendants (Davis) cross-claims against third parties claiming violation of the anti-fraud provisions of the federal securities Acts and also alleges claims under state law based on the same facts; and where the initial foreclosure action is concluded and the remainder of the action on Davis' cross-claims is transferred to the Central District of California; and where, before

trial, the District Court grants cross-defendants' motion for summary judgment on the ground that there is no "security" involved and also dismisses the related state law claims; did the District Court have discretion to dismiss the state law claims, and if so, was the dismissal an abuse of that discretion?

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STATUTES AND RULES

I. Statutes.

The statutes involved are:

Section 2(1) of the Securities Act of 1933 (15 U.S.C. 77b(1)), which states:

> When used in this subchapter, unless the context otherwise requires--
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil , gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 3(a)(10) of the Securities and Exchange Act of 1934 (15 U.S.C. 78c(10)), which states::

> (a) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

II. Rules.

The Rules involved are:

F.R.C.P. Rule 13, subsections (g), (h) and (i):

> (g) Cross-Claim Against Co-Party. A pleading may state as a cross-claim by one party against a co-party arising out of the transaction or occurrence that is the subject matter either of the original action or of a counterclaim therein or relating to any property that is the subject matter of the original action. Such cross-claim may include a claim that the party against whom it is asserted is or may be liable to the cross-claimant for all or part of a claim asserted in the action against the cross-claimant.
>
> (h) Joinder of Additional Parties. Persons other than those made parties to the original action may be made parties to a counterclaim or cross-claim in accordance with the provisions of rules 19 and 20.
>
> (i) Separate Trials; Separate Judgments. If the court orders separate trials as provided in Rule 42(b), judgment on a counterclaim or cross-claim may be rendered in accordance with the terms of Rule 54(b) when the court has jurisdiction so to do, even if the claims of the opposing party have been dismissed or otherwise disposed of.

STATEMENT OF THE CASE

Petitioner here appealed from the decision and judgment of the United States District Court for the Central District of California to the Court of Appeals for the Ninth Circuit. A copy of the District Court's Memorandum of Decision and Order (hereinafter "District Court Decision") is contained in the Appendix to the Petition; the Opinion of the Ninth Circuit Court of Appeals (hereinafter "9th Circuit Opinion") is also contained in the Appendix to the Petition. Respondent Rutan & Tucker (hereinafter "Rutan") will hereinafter refer to both lower court opinions by reference to the Petition Appendix (hereinafter "Petition App.")

The District Court Decision was rendered upon a motion for summary judgment brought by cross-defendant Himmelfarb and joined in by cross-defendants GAGE, Kitch-

ens and Miller. The motion sought dismissal of Petitioner's cross-claims against cross-defendants on the ground that no "security" was involved under federal law and therefore there was no federal question; and that further, Petitioner's related state law claims should also be dismissed. The District Court granted the motion for summary judgment.

Respondent Rutan had been served in the District Court action only shortly before Himmelfarb's motion for summary judgment was filed. Rutan filed no responsive pleadings in the District Court for the reason that the District Court's ruling on the motion for summary judgment rendered the need to do so moot.

The District Court Decision sets forth the facts relevant to the determination of the issues raised in the summary judgment motion, which are the same issues

presented in the Petition. The District Court Decision states, in conclusion:

> The foregoing shall constitute the Court's findings of fact and conclusions of law.
> (Petition App. p. 19.)

Petitioner presents two questions of law to this Court. Although he spends the first 24 pages of the Petition discussing "facts", that discussion contains largely extraneous material, and much of which contradicts the District Court's findings of fact. For purposes of determining whether to review the questions raised, the only "facts" properly before this Court are those in the District Court's findings. Those facts are as follows.

Plaintiffs [Danners and Gadan, Inc.] conveyed two parcels of property in Oregon to defendants Hays and Himmelfarb in 1981 in exchange for a deed of trust on one of the parcels. Hays and Himmelfarb conveyed to plaintiffs a security interest in prop-

erty located in Laguna California.

Defendant Hays and defendants and cross-defendants Himmelfarb, Edwards, Iseli, Kitchens and Miller are shareholders, directors or officers of cross-defendant Golden Arrow Gas Energy Corp. ("GAGE"). GAGE is an Oklahoma corporation of which cross-defendant Empire Equities, Inc. ("Empire") is a subsidiary. Edwards, Hays, Miller, Kitchens and Stepp are officers and directors of Empire.

In June, 1982, defendants Hays and Himmelfarb conveyed another security interest in the Oregon property to an Oklahoma bank. Thereafter, defendants conveyed the property to GAGE, which in turn conveyed it to Empire in exchange for an 80 percent ownership share in Empire.

Late in 1982, Empire decided to pursue investment opportunities in Mexico. To finance the investment, it decided to

obtain pesos and ran an advertisement in the Wall Street Journal soliciting pesos.

In November, 1982, cross-claimant Davis [Petitioner] learned from his daughter, an Empire employee, that Empire was looking for pesos. Davis told his daughter that he might be interested in discussing the sale of pesos. Davis' daughter introduced him to Stepp, Hays and Garrett, who offered Davis oil and gas leases in exchange for pesos. Davis declined this offer.

A number of terms were discussed and the parties ultimately agreed that Davis would transfer approximately $400,000 worth of pesos to Empire in exchange for a note for $400,000 secured by the Oregon real property. The note provided for the quarterly payment of interest to Davis at the prime rate plus one percent with the principal due in 48 months. The note in-

cluded an acceleration upon default clause. Davis claims he was led to believe he was given a first lien on the Oregon property. However, Davis' lien was subordinate to plaintiff's lien and to the bank's lien.

Plaintiffs filed this action in February, 1984 against Hays, Himmelfarb, Empire, Davis, the bank, and others in the District Court of Oregon on the basis of diversity of citizenship. They sought to foreclose their lien on the Oregon properties after defendants Hays and Himmelfarb defaulted on the payments. The court entered an order of foreclosure in August, 1985. The action was thereafter transferred to this Court.

Davis filed his initial answer and counter-claim against Himmelfarb, Hays, Edwards and Empire. With leave of Court, he later amended to add Stepp, Kitchens,

and GAGE as cross-defendants. Davis' Second Amended Cross-Claim added Iseli, Miller and Ganant as cross-defendants. The Third Amended Cross-Claim added Robert Pike and Rutan & Tucker, a law firm. . . .

Plaintiff's claims against all parties have been resolved. Davis' cross-claims are all that remain in this action. (Petition App. pp. 3-7)

* * *

. . . Davis' note was a privately negotiated transaction secured by real property. Uncontradicted testimony indicated Davis rejected other forms of structuring the deal. Particularly, Davis testified that he rejected an offer of an interest in the investment in Mexico because "I wasn't interested in the investment." (Petition App. p. 10.)

* * *

Davis' note was secured by a lien on

the Oregon real property. However, defendants reserved the right to substitute any other real property as collateral. . . . Davis alternately argues that the loan was not in fact collateralized because the lien defendants gave him was worthless.

The mere fact that Davis was deceived as to the priority of the lien does not make the transaction a security. (Petition App. p. 11.)

. . . [T]he obligation at issue appears to be a garden variety privately negotiated loan secured by real property. . . . In [Davis'] deposition testimony he unambiguously disclaimed any interest in Empire's Mexico investment and affirmed that Empire's obligation to Davis had no relationship to Empire's success or failure in that venture. (Petition App. p. 12.)

* * *

Davis notes that at the time he transferred the pesos to Empire, the corporation had a negative net worth. . . . Davis' testimony at his deposition unequivocally establishes that he looked to the collateral to secure repayment, not to Empire's entrepreneurial efforts. He characterizes the transaction as follows: "I was selling them pesos; they were buying pesos in exchange for a note. And again, what they decided to do with those pesos was their business." It is clear that Davis viewed himself as a secured creditor who would be protected even if the business failed.

* * *

As noted above, Davis' own testimony establishes that although he knew the

pesos were to be used to invest in Mexico, he did not view repayment of his note as dependent on the success of the venture. (Petition App. pp. 12-14.)

Davis claims that Empire's offer to buy pesos was part of a larger public offering. The only evidence Davis offers in support of this contention is that Empire advertised in the Wall Street Journal soliciting pesos and corresponded extensively with prospective sellers.

However, the circumstances surrounding Davis' deal with Empire belie any analogy to a public offering. Davis was put in contact with Empire through his daughter. . . .Davis conducted extensive negotiations and participated actively in determining the structure of the transaction. Moreover, it was Davis who demanded that the note be secured by a lien on real property. Additional uncontroverted tes-

timony suggests that the payment schedule on the note was set up to accommodate Davis' personal tax considerations. (Petition App. pp. 14-15.)

Based upon its findings of fact as set forth above, the District Court determined that Davis' Promissory Note and Deed of Trust did not constitute a "security" as defined in the federal securities law and granted summary judgment to the moving cross-defendants accordingly. The District Court also dismissed Davis' related state claims which were based on the same operative facts as the federal claims.

SUMMARY OF ARGUMENT

Question No. 1. Does Davis' Note and Deed of Trust Constitute a "security?"

The Petition does not raise any "special and important" question of federal law.

The decisions of the Courts of Appeals are not in conflict regarding whether a "note" is a security even though they use different analytical approaches. Under the guidelines laid down by this Court, all Circuits agree that not all "notes" are securities and that the cases must be decided in their own context and circumstances. This includes the Second Circuit. Petitioner's contention that it uses a "literal" approach as opposed to the other Circuits is contradicted by the Second Circuit's own opinion.

The Ninth Circuit's decision follows the decisions of this Court regarding

whether a note is a security, in particular Marine Bank v. Weaver. Further, Petitioner's reliance on this Court's opinion in Landreth Timber Co. v. Landreth is misplaced as that case is distinguishable on its facts because it expressly states that it is limited to "stock", as opposed to "notes."

There is no important question of federal law to settle as the decisions of this Court have already settled it.

Question No. 2: Was the District Court's Dismissal of Davis' Related State Law Claims In Error?

There is no important question of federal law to settle. The District Court had discretion to dismiss the state law claims after granting summary judgment on the ground that there was no "security" involved under federal law. The distinction between "ancillary" and

"pendent" jurisdiction is of no substance for purposes of this question according to the decisions of this Court. It is well settled that, even though a District Court has the power to hear related state claims, when the federal claim is dismissed before trial, the District Court should dismiss the state claims as well.

The District Court did not abuse its discretion by dismissing the state claims. It followed the decisions of this Court and also considered the relevant factors in making its decision.

WHY CERTIORARI SHOULD NOT BE GRANTED

I. Question No. 1: Whether Davis' Promissory Note and Deed of Trust Constitute a "Security".

A. Introduction.

Petitioner has the burden of demonstrating to this Court that there are "special and important" reasons for granting review. Supreme Court Rule No. 17.1. Petitioner seeks review of this question by contending: (1) that the Ninth Circuit's decision is in conflict with the decisions of other Circuit Courts of Appeal on this issue; (2) that the Ninth Circuit's decision is contrary to law; and (3) that this is an important question of federal law which this Court should settle. (Petition, pp. 47-48.) The Petition fails to achieve its purpose.

B. The Circuit Courts of Appeal Are Not In Conflict.

Petitioner's contention of "conflict" rests on the fact that different Circuits

have employed different analytical approaches to determine whether to characterize a "note" as a security. An examination of the cases discloses that the fundamental premises employed are the same and that various "approaches" do not constitute a conflict because the Circuits have all followed the guidelines laid down by this Court.

It is apparent that not all "notes" can be "securities." It would be impossible for it to be otherwise. "Any note", literally interpreted, would mean millions of private and small commercial loans reflected in promissory notes, every real estate loan, every I.O.U. of whatever amount and based on every conceivable transaction, would be a "security" invoking the jurisdiction of the federal courts. This Court has established guidelines for the lower federal courts which

establish operative limits on the broad statutory definitions.

> The definition of "security" in the Securities Exchange Act of 1934 is quite broad. . . .
>
> The broad statutory definition is preceded, however, by the statement that the terms mentioned are not to be considered securities if "the context otherwise requires. . . ." Moreover, we are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud. Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1253 (CA9 1976); Bella v. First National Bank, 495 F.2d 1109, 1114 (CA5 1974).

Marine Bank v. Weaver, 455 U.S. 551, 555-556 (1982).

In Marine Bank, this Court held that a bank certificate of deposit and a related pledge agreement were not "securities."

> . . . The definition of "security" in the 1934 Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires.
>
> * * *

> Congress intended the securities laws to cover those instruments ordinarily and commonly considered to be securities in the commercial world.
>
> (455 U.S. at 558-559.)
>
> . . . Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.
>
> (455 U.S. at 560, n. 11.)

It must be, and is, recognized that the factual circumstances in which notes may be involved are too numerous and varied to allow for a precise and concrete rule for determining which notes are and which are not securities. Each case must be decided in its own context. The Courts of Appeal have followed the lead provided by this Court in such cases as United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975):

> Because securities transactions are economic in character Congress intended the applications of these statutes to turn on the economic realities underlying a transaction and not on the name appended thereto.

In Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1256 (CA9 1976), it was observed:

> The courts of appeals have followed this "economic realities" approach in holding that these statutory definitions should not be taken literally and that not all "notes" are securities: . . .

The Kotz decision cites examples from the Second, Third, Fifth and Seventh Circuits for this proposition.

Petitioner's claim of conflict in Court of Appeal decisions rests mainly on the claim that the Second Circuit has taken a "literal" approach, rejecting the "functional" approaches of the other Circuits and citing Exchange National Bank of Chicago v. Touche Ross & Co., 544 F.2d

1126 (CA2 1976) for the proposition. But, the Second Circuit disagrees that it uses a literal approach as it makes clear in Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 938 (CA2 1984), Cert. den. 469 U.S. 884, where the court held that notes evidencing loans by banks to a business borrower were not securities.

The Second Circuit's approach in both cases is that the person asserting that the note in question is not a "security" has the burden of showing that "the context otherwise requires." In Exchange National Bank it had listed a number of examples of cases where the context did otherwise require, e.g., "a note secured by a mortgage on a home", and stated that a note which bore a "strong family resemblance" to the examples listed would not be considered a security. (544 F.2d at 1138.) In Chemical Bank, the Second Cir-

cuit stated that it was not overruling its earlier approach, but simply adding the type of notes involved there to its list. (726 F.2d at 939.)

Importantly, the Second circuit in Chemical Bank gave substantial consideration to this Court's opinion in Marine Bank, supra. In particular, it was guided by this Court's statement that Congress did not intend to provide a broad federal remedy for fraud and by this Court's approving reference to Judge Wright's concurring opinion in Great Western Bank v. Kotz, 532 F.2d 1252 (CA9 1976) which had noted that an unsecured note, the terms of which were negotiated face-to-face, given to a bank in return for a business loan, is not a security. (726 F.2d at 938.)

Petitioner has not shown that any conflict exists in the decisions of the Courts of Appeal on the question of

whether a "note" is a "security". All of them exclude some notes, when the context otherwise requires. Since it is impossible to anticipate every possible permutation of note, circumstance and context, the lower courts must rely on the broad statutory language and this Court's guidelines. Petitioner has not demonstrated that any of the Courts of Appeal have failed to do that in developing their own "approaches" to deciding the unique cases which confront them.

C. The Court of Appeals' Decision Follows Applicable Decisions of This Court.

Petitioner's contention that the Court of Appeals' decision conflicts with applicable decisions of this Court is substantially answered in the preceding section. In particular, this Court's decision in Marine Bank is the most applicable. In that case, Plaintiffs purchased a

$50,000 certificate of deposit from the bank and later pledged it to the bank to guarantee a loan to a corporation, Columbus Packing Co. In consideration for the pledge, Plaintiffs were to receive 50% of Columbus net profits and $100 per month as well as use of certain of Columbus' property during the term of the pledge. This Court held that neither the certificate of deposit nor the pledge agreement was a security. With regard to the latter, the Court stated:

> . . .The unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case. . . . The instruments involved in C.M. Joiner and Howey had equivalent values and could have been traded publicly.
>
> Here, in contrast, the Piccirillos distributed no prospectus to the Weavers or to other potential investors, and the unique agreement they negotiated was not designed to be traded publicly. . . . Accordingly, we hold that this unique

> agreement, negotiated one-on-one by the parties, is not a security.
>
> (455 U.S. at 560)

In the instant case, there was no public offering and no prospectus offered to Davis or any other person. Empire was in the market for pesos and Davis had pesos for sale. The parties negotiated one-on-one, eventually arriving at a unique agreement on terms substantially dictated by Davis' requirements. Davis had no interest whatever in investing in Empire's projects nor in what Empire intended to do with the pesos it acquired from him. Considering the decision in Marine Bank, the Court of Appeal had no choice but to uphold the District Court decision that Davis' promissory note and deed of trust were not a security.

Petitioner's reliance on Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) does not change anything. The

issue there was whether the sale of 100% of the stock of a company was excluded from the anti-fraud provisions of the securities laws as some Courts of Appeal had held. This Court held that the transaction was the sale of "securities", observing that stock was unique among all the items listed in the statutory definition of "security":

> Although we do not decide whether coverage of notes or other instruments may be provable by their name and characteristics, we do point out several reasons why we think stock may be distinguishable from most if not all of the other categories listed in the Acts' definition.
>
> Instruments that bear both the name and all of the usual characteristics of stock seem to us to be the clearest case for coverage by the plain language of the definition.
>
> * * *
>
> . . . We here expressly leave until another day the question whether "notes" or "bonds" or some other category of instrument listed in the definition might be shown "by proving [only] the document itself." SEC v. C.M. Joiner Leasing Corp., supra, at

> 355. We hold only that "stock" may be viewed as being in a category by itself for purposes of interpreting the scope of the Acts' definition of "security."

(471 U.S. at 693-694.)

There is absolutely nothing in Landreth with which the Court of Appeals decision conflicts. Not only are the two cases completely distinguishable on their facts, this Court expressly stated that it was not dealing with the term "notes" under the securities laws, thus limiting the decision to the case of stock.

D. There is No Important Question of Federal Law For This Court to Settle

Petitioner has made no showing that this Court should be interested in taking this case for the purpose of settling an important question of federal law. The law is probably as clear as the lower courts and this Court can make it with respect to "notes." This Court has established clear working guidelines consistent

with the text and the purposes of the securities Acts. The lower courts have followed those guidelines in the many and varied contexts in which "notes" are used by businesses and individuals. As this Court stated in Marine Bank:

> . . . Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.
>
> (455 U.S. at 560, n. 11.)

This Court has already settled the question about as well as it can be in a complex world where decisions are made by fallible human beings. The fact that this Court declined to review the Second Circuit's decision in Chemical Bank, supra, is some indication that the question is already well settled.

II. Question No. 2: Was the District Court's Dismissal of Davis' Related State Law Claims In Error?

A. Introduction.

Petitioner seeks review of this question by contending: (1) that this is an important question of federal law which this Court should settle, and (2) the District Court abused its discretion in dismissing Petitioner's state law claims after a successful summary judgment motion removed his federal law claim from the action. (Petition, pp. 61-62.) The Petition fails to achieve its purpose.

B. There is No Important Federal Question for This Court to Settle.

Petitioner seeks to make a simple issue complicated. There was never any question that the Oregon District Court had diversity jurisdiction in the original action and ancillary jurisdiction over Davis' cross-claims and the cross-defendants he sued. After the original

plaintiffs' action was reduced to judgment in Oregon in 1985 and the case was transferred to the Central District of California, Davis was in the position of a Plaintiff with a federal securities Act claim and state law claims based on the same facts. Before trial, certain cross-defendants moved for summary judgment. District Court Judge Kelleher granted the motion, and, because the securities Act claim was thereby removed, also dismissed the related state law claims.

The simple question is whether the District Court was obligated by law to retain Davis' state law claims. The simple answer is: No.

The distinction between "ancillary" and "pendent" claims for this purpose is of no consequence, even though Petitioner belabors the point. In Owen Equipment & Erection Co. v. Kroger, 437 U.S. 365, 370

(1978), this Court made it clear that the labels indicate a difference of no substance:

> . . . Gibbs and this case are two species of the same generic problem: Under what circumstances may a federal court hear and decide a state-law claim arising between citizens of the same State?

The leading cases in this area involve the jurisdictional power of the federal courts to hear matters arising under state law when connected to federal law claims. Even in cases where they have it, the courts have been reluctant to exercise that power and the clear rule is that state law claims should be dismissed where the federal claim is removed from the case, particularly if this occurs before trial. The leading case is United Mine Workers v. Gibbs, 383 U.S. 715 (1966):

> . . . It has consistently been recognized that pendent jurisdiction is a doctrine of discretion, not of plaintiff's right. . . . Certainly,

> if the federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well. Similarly, if it appears that the state issues substantially predominate, whether in terms of proof, of the scope of the issues raised, or of the comprehensiveness of the remedy sought, the state claims may be dismissed without prejudice and left for resolution to sate tribunals. . . .
>
> The question of power will ordinarily be resolved on the pleadings. But the issue whether pendent jurisdiction has been properly assumed is one which remains open throughout the litigation. . . . [R]ecognition of a federal court's wide latitude to decide ancillary questions of state law does not imply that it must tolerate a litigant's effort to impose upon it what is in effect on a state law case. Once it appears that a state claim constitutes the real body of the case, to which the federal claim is only an appendage, the state claim may fairly be dismissed.

(383 U.S. at 726-727; emphasis supplied.)

In the portion of the foregoing passage stating that the state claims should be dismissed when the federal claim is dismissed before trial, the Court, in a foot-

note, cites a Ninth Circuit case, Wham-O-Mfg. v. Paradise Mfg. Co., 327 F.2d 748 (CA9 1964), for the proposition.

Wham-O-Mfg. is on all fours with the instant case. It involved a federal patent infringement claim to which was appended a state law unfair competition claim. A pre-trial motion for summary judgment disposed of the patent infringement claim and the District Court dismissed the state law claim. The Ninth Circuit Court of Appeals stated:

> And in the case before us, although we are satisfied the district court did have jurisdiction over the non-federal subject matter, we believe that on the this record the court, in the exercise of a sound discretion, had no choice but to dismiss the complaint with respect to that claim.
>
> (327 F.2d at 753.)

Petitioner's contention that the District Court was somehow obligated to retain jurisdiction of the state law

claims after disposal of the federal claims has no support in the well settled and controlling case law. Indeed, his position is clearly contrary to the law. Petitioner contends that F.R.C.P rule 13(i) compels the result he desires. (Petition, p. 61.) But the Rule is clearly permissive, not compulsory. Petitioner has attempted to create an issue to engage the curiosity of this Court where there is no such issue. Nothing here remotely approaches being "an important issue of federal law which has not been, but should be, settled by this Court."

C. There was No Abuse of Discretion.

Petitioner contends that so much pre-trial discovery and preparation had occurred before the action was dismissed, that the dismissal should be deemed an abuse of discretion. (Petition, p. 62.) This contention is disposed of by the dis-

cussion and authorities cited in the preceding section. Further, as the Court of Appeals observed, the District Court gave due consideration to the relevant factors of judicial economy and fairness. (Petition App., p. 58-59.) The record here contains not a hint that either the District Court or the Court of Appeals abused its discretion.

CONCLUSION

Petitioner has given this Court no "special and important reasons" to review the decision of the Court of Appeals or the District Court. Petitioner's request for a Writ of Certiorari should be denied.

Respectfully submitted,

LAW OFFICES OF STUART T. WALDRIP,
A PROFESSIONAL CORPORATION

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By: _____
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Supreme Court, U.S.
FILED
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CLERK

No. 88-1554

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1989

VINCENT E. DAVIS,

Petitioner,

vs.

HENRY HIMMELFARB; CHARLES T. HAYS; RICHARD A. EDWARDS; GOLDEN ARROW GAS ENERGY CORPORATION; JIM KITCHENS; RONALD G. MILLER; RUTAN & TUCKER; ROBERT PIKE; EMPIRE EQUITIES; RONALD GARRETT,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Is a secured note, the terms of which were negotiated by all parties to the transaction a security as defined by section 3(a) of the Securities & Exchange Act of 1934, 15 USC §78 (c)(a)?

2. Does a Federal District Court have discretion to dismiss state claims, whether ancillary or pendent, after the resolution of the federal claim?

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Respondents.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

RESPONDENTS' BRIEF IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is reported at 858 F.2d 515 ("Danner, et al., v. Himmelfarb, et al. and related cross-actions", Pet. App. A 22-59 [1]/

[1] "Pet. App." refers to Petitioner's Appendix.

The memorandum opinion of the United States District Court for the Central District of California (Pet. App. A1-19) has not been officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on September 28, 1988. Petitioner's petition for rehearing was denied on December 15, 1988. (Pet. App. A60-61) The jurisdiction of the Court is invoked by Petitioner under 28 U.S.C. 1254(1).

STATEMENT OF THE CASE

By perceiving a departure from firmly

anchored securities precedent by the Court of Appeal, where no departure exists, Petitioner challenges a well thought out and reasoned opinion of the court. Until now, a party could not be held liable under federal securities law in relation to the issuance of a note which bears none of the long established characteristics of a security. The issue posed by Petitioner's application is whether these longstanding principles of securities law should be abrogated by holding a note a security by proving only the document itself. The facts of this case do not demonstrate a further refining of securities law in the area of the issuance of notes and the petition should be denied. Further, this Court has repeatedly recognized a federal court's wide latitude to decide ancillary or pending questions of state law. The state law claims were properly dismissed

after resolution of the federal questions in this action and for this reason the petition should be denied.

The statement of facts and proceedings below presented by Petitioner is adopted herein with the following corrections:

A. **Statement of Facts**

Petitioner has gone to great lengths to summarize the facts of this case from its inception. The summarization includes a number of extraneous facts and the Court's attention is respectfully directed to those facts which form the basis for the underlying procedural motions and subsequent hearing before the Court of Appeals.

During the latter part of 1982,

Empire Equities, INC. became interested in certain investment opportunities in Mexico. Due to the uncertainty of the monetary situation in that country, the directors of Empire decided to obtain peso holdings within Mexico through individuals for use as working capital.

In November 1982, Davis was informed by his daughter Leslie, an employee of Empire, that Empire was looking for pesos for use in connection with some of their Mexico operations. Davis, who had large holdings of Pesos within Mexico, told his daughter that he might be interested in discussing the transfer or selling of pesos to Empire. A meeting was subsequently arranged with Davis and certain principals of Empire to effectuate this transaction. Initially, the officers of Empire offered Davis oil and gas mineral interests in

exchange for his pesos. Davis declined this offer, as he later declined the opportunity to exchange his pesos for a share of the profits from the Mexican venture Empire was pursuing. Davis eventually negotiated to receive from Empire a promissory note in the principal sum of $400,000, payable in United States currency, with quarterly interest to be paid at an annual rate of prime plus one percent, with interest payments to commence in June 1984 in exchange for his pesos. Davis insisted that the note be secured by a first lien deed of trust. Empire agreed and granted Davis a lien on property in Oregon. Davis did not realize that this lien was subordinate to the liens of the original plaintiffs in this action (the Danners and Gadan, Inc. and an Oklahoma bank.)

B. **The Proceedings Below**

In February 1984 plaintiffs Danner and Gadan filed a suit to foreclose their deed of trust on the Oregon property. The suit was commenced in the United States District Court for the District of Oregon and Petitioner Davis was named as a defendant. Davis answered the plaintiff's complaint and cross-complained against his co-defendants Hays, Himmelfarb, Edwards and Empire. He alleged a securities law claim for fraud, as well as several state law claims. The court severed Davis' cross-claims for a separate trial. Himmelfarb moved for a transfer of the cross-claims to California. With leave of court, Petitioner Davis amended his cross-claim to add Step, Kitchens and GAGE as cross-defendants. Davis' second amended cross-claim added Iseli, Miller and Ganant as

cross-defendants. The third amended cross-claim added Robert Pike and Rutan & Tucker, a law firm.

Prior to the transfer of the cross-claims to California, the court in Oregon entered an order of foreclosure in August of 1985. The original plaintiffs had no further interest or role in this action after that date.

On or about March 29, 1987, respondent Himmelfarb filed a motion for summary judgment. The basis of that motion was that, as a matter of law, the note issued to Davis was not a security and that the federal securities claims should be dismissed. Additionally, Himmelfarb asked the court to dismiss Davis' pendent state claims.

The District Court granted

Himmelfarb's motion for summary judgment in its entirety and held

> "The court concludes that the application of the risk capital test as to the undisputed facts of this case preclude a finding that the transaction at issue is a security." (Pet. App.A15)

In reaching this conclusion, the court made the following finding; (1) Davis' note was a privately negotiated transaction secured by real property uncontradicted testimony indicated that Davis rejected other forms of structuring the deal, (2) the defendant's right to substitute collateral rendered the importance of collateralization of the loan insignificant for the purposes of characterizing the

transaction, (3) the obligation at issue appeared to be a garden variety privately negotiated loan. Davis had unambiguously disclaimed any interest in Empire's Mexico investment and affirmed that Empire's obligation to Davis had no relationship to Empire's success or failure in that venture. (4) Davis looked to the collateral to secure repayment, not to Empire's entrepreneurial efforts. (5) Davis did not view repayment of his note as dependent on the success of any venture of Empire and (6) the circumstances surrounding Davis' deal with Empire belied any and all analogy to a public offering. Davis conducted extensive negotiations and participated actively in determining the structure of the transaction. Moreover, it was Davis who demanded that the note be secured by a lien on real property. Additional uncontroverted testimony suggested that the

payment schedule on the note was set up to accommodate Davis' personal tax considerations. (Pet. App. A9-15)

Finally, the court held that there was no reason to retain jurisdiction over the state causes of action and dismissed them. While noting that the procedural posture of this action rendered the question of the court's subject matter jurisdiction over the remaining claims somewhat complex, the court found that the assertion of jurisdiction was discretionary and after balancing considerations of judicial economy and fairness to the parties, declined to retain the state claims.

Petitioner appealed the entry of summary judgment in favor of respondents to the United States Court of Appeals for the Ninth Circuit. On that appeal, (Danner, et

al. v. Himmelfarb, et al. and related cross-claims) the Ninth Circuit Court of Appeals affirmed the District Court's granting of summary judgment on the ground that the Empire note was not a security and therefore there was no federal securities law subject matter jurisdiction. Additionally, the court affirmed the dismissal of Davis' state law claims.

In affirming summary judgment in favor of respondents, the Court of Appeals held that the context of the underlying transaction was such that it was clear that no "security" was involved and that therefore it was not necessary for the court to apply the "risk capital" test since the question of whether the instrument constituted a "security" was not a close one. (Pet. App. A37.)

Noting that the nature of an

instrument is to be determined at the time of the issuance, not at some subsequent time, the court stated

> "Davis sold an asset in exchange for a promissory note secured by a deed of trust. Davis did not "invest" his money in Empire or Empire's planned Mexican venture. He did not expect "profits" in the sense of either capital appreciation or a share of the earnings from a business venture formed with the borrowed capital. (Citations) Davis did not 'lend' Empire money, except to the extent that any sale of an asset in exchange for a promissory note represents the sellers loan to the buyer of a portion of the purchase price.

> Based on the context of the transaction and its economic realities, we agree with the District Court that Empire's note is not a 'security' for purposes of the Federal Securities Law."

In addressing the question of the dismissal of Davis' state law claims the court held

> "Whether Davis' state law claims are pendent to his federal cross-claim or are ancillary to the original action is irrelevant because, viewed either way, identical considerations lead us to conclude that the court did not abuse its "broad discretion" by dismissing the state law claims. (Pet. App. A51)

Subsequent to the decision of the United States Court of Appeals for the Ninth Circuit, petitioner sought rehearing or rehearing en banc. On December 15th, 1988, the panel unanimously voted to deny the petition for rehearing and to reject the suggestion for a rehearing en banc.

The matter now comes before the Court on Davis' Petition of Certiorari to the Ninth Circuit Court of Appeals.

REASONS FOR DENYING THE WRIT

A. The Peculiar Facts Of This Case Do Not Warrant Reexamination Of Federal Securities Law And This Writ Should Be Denied.

Petitioner would have this Court

extend its ruling in Landreth Timber Company v. Landreth, 471 U.S. 681, 105 S.Ct.2297, 85 L.Ed.2d 692 (1985) to the question of whether a note should be deemed a security based solely on its title and characteristics. In Landreth, this Court rejected the sale of business doctrine in relation to the determination of whether stock should be treated as a "security" and held that the particular characteristics of stock made it susceptible to a plain meaning approach in determining whether or not that stock was a "security." In persuasive dicta, this court pointed out several reasons why stock was distinguishable from most, if not all, of the other categories listed in the Acts definition of security.

First, traditional stock "represents to many people both

> trained and untrained in business matters the paradigm of a security." ... Second, as we made clear in Forman, "stock" is relatively easy to identify because it lends itself to consistent definition. (Id. at 693)

On the other hand, the court pointed out that a "note" should be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending upon whether issued in a consumer context, as commercial paper, or in some other investment context. (Landreth Timber Company v. Landreth, supra, at pp. 693-694) Clearly, as the facts of this case highlight, a note is not a category of instruments in the Acts definition that might be shown by proving

only the document itself. Moreover, while holding that "stock" was particularly susceptible to being proved by its characteristics, the court noted that it was still important that the context of the transaction sought to be placed within the scope of the securities laws be examined when deciding whether some financial instrument is a "security". (Landreth Timber Company v. Landreth, supra, at 687) Thus, the court's approach in Landreth did not require the Court of Appeals to ignore the economic realities in the context of the underlying transaction in declining to label Empire's note to Davis as a security.

While respondent acknowledges that the Circuit Courts have used different methods of analysis for determining whether an instrument is a "security", the great majority of cases examine the context of

the transaction in order to determine whether or not the transaction falls within the coverage of Federal Securities law. See United Sports Fishers v. Buffo 597 F.2d 658 660 (9th Cir. 1978; Exchange National Bank of Oregon v. Touche Ross, 546 F.2d 1126, 1137-38 (2d Cir., 1976); Zeller v. Bogue Electric Manufacturing Corporation, 476 F.2d 795, (2d. Cir.,), Cert. denied 414 U.S. 908, 94 S.Ct. 217,38 L.Ed.2d 146 (1973) Leino v. City Investing Company. 487 F.2d 689 (3d Cir., 1973); McClure v. First National Bank of Luvick 497 F.2d 490 (5th Cir., 1974), Cert. denied 420 U.S. 930, 95 Sup.Ct. 1132, 43 L.Ed.2d 402 (1975)

The uncontroverted evidence in this case makes clear that the context of the transaction took it outside the scope of securities regulation. Petitioner sold an asset in exchange for a promissory note

secured by a deed of trust. Petitioner did not "invest" his money in Empire or Empire's planned Mexican venture. He did not expect "profits" in the sense of either capital appreciation or a share of the earnings from a business venture formed with the borrowed capital. Nor did petitioner lend Empire money, except to the extent that any sale of an asset in exchange for a promissory note represents the sellers loan to the buyer of a portion of the purchase price. Whether this transaction is examined under the Ninth Circuit's "risk capital" test or if it is viewed only in the context of the transaction itself, the result is the same, this note was not a security.

Petitioner has shown no good reason why this court should reexamine the holding of the United States Court of Appeals for

the Ninth Circuit and for these reasons respondent respectfully request that this Petition be denied.

B. **Whether The State Claims Are Ancillary Or Pendent, The Decision To Exercise Jurisdiction Remains a Discretionary Function.**

The decision by the Court of Appeals to affirm dismissal of the state claims rests on years of uniform precedent. In United Mine Workers v. Gibbs, 383 U.S. 715 (1966), this Court formulated a framework for the analysis of factors that a court should consider before retaining jurisdiction over non-federal claims. The suit in Gibbs involved a state claim of malicious interference with contract appendant to a federal, secondary boycott claim. The test that the court enunciated

was that

> "... If, considered without regard to their federal or state character, a plaintiff's claims are such that he would ordinarily be expected to bring them all in one judicial proceeding, then, assuming the substantiality of the federal issues, there is power in the Federal Courts to hear the whole. (Id., at 725 (Citations omitted). However, this court noted "... pendent jurisdiction is a doctrine of discretion, not of plaintiff's right. Its justification lies in consideration of judicial economy, convenience and fairness to litigants; if these are not present a Federal Court should

hesitate to exercise jurisdiction over state claims, even though bound to apply state law to them ..." Id. at 726 (fn. and citation omitted).

The District Courts have applied the analysis developed in Gibbs, a pendent jurisdiction case, to suits like the present case that raise questions about the retention of ancillary jurisdiction after dismissal of the federal claims. See, e.g., Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 458 (7th Cir. 1982), Cert. denied, 459 U.S. 880; Waste Systems, Inc. v. Clean Land, Air and Water Corporation, 683 F.2d 927 (5th Cir. 1982), United States v. Zima, 766 F.2d 1153 (7th Cir., 1985).

Moreover, the Federal Appeals Courts in general have indicated a strong

preference for the dismissal of pendent or ancillary claims whenever the District Court disposes of the federal claim or claims prior to trial. Indeed, in cases involving complex or novel issues of state law, the appellate courts have held that it is an abuse of discretion to retain jurisdiction after the federal issue is disposed of at trial or even on appeal. See, e.g., Federman v. Empire Fire & Marine Insurance Company, 597 F.2d 798, 811 (2d Cir. 1979); Hodge v. Mountain State Telephone & Telegraph Company, 555 F.2d 254 (9th Cir. 1977); American National Bank & Trust Co. v. Bailey, 750 F.2d 577, 581 (7th Cir. 1984).

It is therefore clear that whether these claims are viewed as pendent or ancillary makes no difference to the determination of whether or not the court

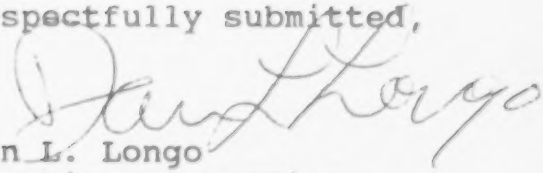
should have retained jurisdiction over the state claims. As the Court of Appeals for the Ninth Circuit pointed out, the decision to exercise jurisdiction is always discretionary. The trial court properly examined the relevant factors and determined that, on balance, it should exercise its discretion and decline to retain the state claims. (Pet. App. A58-59) Petitioner has shown no good reason why this court should reexamine the decision of the Court of Appeals for the Ninth Circuit nor has petitioner showed a gross deviation from the guidelines enunciated by this court in United Mine Workers v. Gibbs. For these reasons, the Petition for Writ should be denied.

CONCLUSION

No matter how many different tests under which this transaction is examined, the fact remains that in the particular circumstances and context of this transaction, the note in question was not a security. Nothing in the particular facts of this case warrants uprooting this decision. Moreover, following the decision of this Court in United Mine Workers v. Gibbs, the lower courts have uniformly held that the decision whether to retain jurisdiction over pendent or ancillary claims is a matter left to the sound discretion of the trial court. Again, nothing in the peculiar facts of this case warrant uprooting this time honored rule.

For the foregoing reasons, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,



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